742-B Ju 11.7/2:1986-1

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T. C. Memo. 1986-1

UNITED STATES TAX COURT

THOMAS L. WICKER AND BETTYE WICKER, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 11064-84. Filed January 2, 1986.

Flavous L. Hutchinson, for the petitioners.

J. Craig Young, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

KORNER, Judge: Respondent determined deficiencies in petitioners' income tax for the years 1979 and 1980, in the respective amounts of $1,885 and $3,438.49. After concessions, the only remaining issues which we must decide are the deductibility, in the years 1979 and 1980, of certain expenses

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incurred by petitioner Bettye Wicker in the ownership and operation of an automobile, and the allowability of an investment tax credit to her for the purchase of an automobile in 1980.

Many of the facts herein were stipulated, and such stipulation, together with accompanying joint exhibits, is incorporated herein by this reference.

FINDINGS OF FACT

Petitioners were residents of New Albany, Mississippi, at the time their petition herein was filed. For the calendar years 1979 and 1980 petitioners filed joint individual income tax returns with the Internal Revenue Service Center at Chamblee, Georgia.

During the years in issue, as well as for a number of years prior thereto, petitioner Bettye Wicker (hereinafter "petitioner")[1] was a self-employed individual practicing the profession of nurse-anesthetist. In 1979 and 1980, petitioner practiced her profession in part at the Union County General Hospital (hereinafter "the hospital"), in New Albany, Mississippi. She was not an employee of the hospital and was not paid a salary. Under her contract with the hospital (in oral form in the years before us, but later reduced to written form) petitioner served as the working head of the Department of Anesthesiology at the hospital.[2/]

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[1] Petitioner Thomas L. Wicker is involved herein only because of signing a joint return with petitioner Bettye Wicker for the years in issue, and he will not be referred to hereinafter.

It was petitioner's responsibility to provide anesthesia services for all hospital patients, when required. The regular operating schedule at the hospital was from Monday through Friday, beginning at about 9:00 a.m., with extraordinary or emergency surgery performed on Saturdays. The great majority of anesthesia in the hospital in the years in question was administered by petitioner personally, at the rate of 120 to 140 patients per month. If a case arose where petitioner was not available for any reason, she had to arrange for another qualified anesthetist on the day or the night preceding the scheduled operation, and she was responsible for the satisfactory performance of such other anesthetist.

Petitioner charged each patient for the services which she performed in administering anesthesia in accordance with a fee schedule and guideline published by the American Anesthesiology Association. The fees varied with the type and difficulty of the operation involved, and the physical condition of the patient. Petitioner's fees were billed and collected by the hospital, which then deducted an agreed percentage of the fee and remitted the balance to petitioner. Her services to a patient typically

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[2/] Nominally, a self-employed surgeon with practicing privileges at the hospital was designated as Chief of Anesthesia Services, but in fact petitioner ran and was responsible for the department.

included a preoperative visit and interview with the patient, in order to evaluate the patient's condition and special requirements, the administration of anesthesia during the operation, and a post-operative checkup on the patient's condition, with particular attention to any adverse reaction to the anesthetic employed. It was petitioner's responsibility to determine the amount and type of anesthetic to be administered, based upon her evaluation of the surgery involved and the particular patient's condition.

Petitioner was on 24 hour call with the hospital and, when she was not at the hospital or at her home office (hereinafter described) where she could be reached by telephone, she carried a paging device and arranged to be within 15 minutes of a telephone.

So far as this record discloses, petitioner was the only full time anesthetist practicing at the hospital. That institution, however, would not provide any office space for petitioner's use, and accordingly she maintained an office in the basement of her home, which she used exclusively for the practice of her profession. In that office, inter alia, she maintained professional books such as books and manuals on anesthesia. She also maintained a ledger of the cases in which she had served, including the patients' name, copies of the charges which she made with respect to each patient, medical notes related to patients which she was handling, a schedule of her appointments for operations, records of other anesthetists secured by her to perform services at the hospital, and the like, including tax records.

The hospital was accredited by the Joint Commission on Accreditation, and to comply with its requirements, the anesthesia department of the hospital had to have a policy procedure manual. Petitioner wrote this manual herself, first in 1977, and then in 1980 she revised the entire book. The work on this manual was done in her home office, as well as the preparation of lectures and educational material for the one "in-service" day every month which petitioner was required to give in the obstetrical department of the hospital. In the years 1979 and 1980, under the requirements of the Joint Commission on Accreditation, petitioner had to personally prepare and file a report, four times a year, covering the anesthesia treatment given to patients during the preceding quarter. Such reports were prepared by petitioner at her office.

In addition to the various records and educational materials prepared and kept by petitioner in her home office, she also conferred by telephone there with doctors at the hospital, both with regard to scheduling of appointments as well as with respect to the condition of patients, and used her office telephone to arrange for the services of other anesthetists.

Petitioner's office in her home was the only office which she had. She traveled between her home office and the hospital in her own automobile, and frequently made several round trips a day in connection with her duties. For the years 1979 and 1980, petitioner incurred and claimed the following amounts as business deductions with respect to the use of her automobile in traveling between her office and the hospital, and respondent disallowed such claimed deductions, as follows:

Expense		Claimed on Return	Allowed by Respondent	Disallowed by Respondent
Car Expenses	1979	$2,415.00	$ -0-	$2,415.00
	1980	2,777.25	-0-	2,777.25
Insurance	1979	1,554.00	832.12	721.88
	1980	1,971.60	1,554.00	417.60
Car Repairs and Tires	1979	713.12	-0-	713.12
	1980	710.75	-0-	710.75
Car Taxes and Tags	1979	197.57	-0-	197.57
	1980	531.45	-0-	531.45
Depreciation	1979	642.60	163.59	479.01
	1980	3,153.99	153.99	3,000.00
			Totals 1979	$4,526.58
			1980	$7,437.05

In 1980, petitioner purchased an automobile for $10,000. Ninety percent of this automobile's use in 1980 was by petitioner in traveling between her office and the hospital. Petitioner claimed an investment tax credit of $300 with respect to the purchase of this automobile in her 1980 return, which respondent disallowed.

ULTIMATE FINDINGS OF FACT

Petitioner's home office was her principal and only office, in which a substantial part of her work was performed.

The claimed automobile expenses incurred by petitioner in 1979 and 1980 were incurred by her in the pursuit of her trade or business. The automobile purchased by petitioner in 1980 was used to the extent of 90% by her in the conduct of her trade or business.

OPINION

The principal issue in this case involves the deductibility, for Federal income tax purposes, of automobile expenses incurred by petitioner in traveling between her home office and the hospital, in the practice of her profession as a nurse-anesthetist. At the outset, it should be made clear what matters are not in issue: (a) No claimed deductions with respect to petitioner's home office are in dispute, and (b) the fact that petitioner incurred the automobile expenses in question, and the amount thereof, has likewise been stipulated by the parties. What remains, then, is:

> This case presents the old, old question of the tax deductibility of transportation costs going to and from work. [Footnote omitted.] More precisely, the question probably is what is the place of work? * * * [Steinhort v. Commissioner, 335 F.2d 496, 497-498 (5th Cir. 1964)]

Petitioner claims that the automobile expenses here in issue were incurred by her in traveling from her principal office, which was in her home, to the hospital where she assisted in surgery as the anesthetist, and that such expenses are therefore deductible under section 162.3/ Respondent, on the other hand, contends that these automobile expenses were nondeductible personal commuting expenses, incurred by petitioner in traveling to and from her home and the hospital which respondent argues was petitioner's principal place of business, and therefore are not deductible under section 162, by reason of the specific provisions of section 262.4/

3/ All statutory references are to the Internal Revenue Code of 1954, as in effect in the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, except as otherwise noted.

4/ The Code provisions involved here, as relevant, are as follows:

> SEC. 162. TRADE OR BUSINESS EXPENSES.
>
> (a) In General.--There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *
>
> SEC. 262 PERSONAL, LIVING AND FAMILY EXPENSES.
>
> Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses.

Over the years, in interpreting the above Code sections, it has become well established that the expenses which a taxpayer incurs in commuting between his home and place of business are personal and nondeductible. *Commissioner v. Flowers*, 326 U.S. 465 (1946); *Heuer v. Commissioner*, 32 T.C. 947 (1959), affd. per curiam 283 F.2d 865 (5th Cir. 1960). See also sections 1.162-2(e) and 1.262-(1)(b)(5), Income Tax Regs. Expenses incurred on trips between places of business, however, may be deductible. *Steinhort v. Commissioner*, *supra*, affg. and remanding T.C. Memo. 1962-233; *Heuer v. Commissioner*, *supra*; *Sapp v. Commissioner*, 36 T.C. 852 (1961), affd. per curiam 309 F.2d 143 (5th Cir. 1962). To the last proposition, however, a further refinement has been added: that where the taxpayer seeks to deduct the expenses of traveling between two places of business, and where one of such places is an office in his home, such home office must be his principal place of business in which he does a substantial amount of work. *Curphey v. Commissioner*, 73 T.C. 766, 777-778 (1980); *Green v. Commissioner*, 59 T.C. 456, 459 (1972); *Wisconsin Psychiatric Services v. Commissioner*, 76 T.C. 839, 849 (1981). In resolving this last question, "[t]he location of a taxpayer's 'principal office' is a question of fact to be determined by evaluating all the evidence." *Wisconsin Psychiatric Services v. Commissioner*, *supra* at 849.

Taking into account the totality of the circumstances in this case, as disclosed by this record, we hold in favor of petitioner on this issue. Admittedly, the distinctions which are drawn are sometimes fine, and it is not always easy to reconcile the cases involving this troublesome question. The travel involved must be more in the nature of travel between business locations, rather than that of ordinary commuting, see Fryer v. Commissioner, T.C. Memo. 1974-77, and the home office involved must in truth be the taxpayer's principal office, see Watts v. United States, 82-2 USTC par. 9439, 50 AFTR2d 82-5202 (M.D.N.C. 1982). In this case, however, we think the necessary tests have been met.

Unlike the taxpayer in Sheldon v. Commissioner, 50 T.C. 24 (1968) (a doctor/anesthesiologist), petitioner was not an employee of the hospital. She was a self-employed professional, practicing her profession at the hospital under contract with that institution. She thus occupied the same status vis-a-vis the hospital as the surgeons in private practice who operated there and whom she assisted. Under her contract with the hospital, petitioner was responsible for the provision of all anesthesia services there. The evidence shows that about 85% of such services were performed by herself, but if for any reason she was not available, it was her responsibility to provide another qualified anesthetist for the operation. She was on 24-hour call at the hospital, and had to check in with the hospital and the operating surgeons the evening before scheduled operations to make sure of the operating schedule for the following day. Where other anesthetists were required, she had to make these arrangements herself, usually by telephone. In addition to her services in administering anesthetic during an operation, petitioner's contract required her to prepare and revise the policy and procedure manual for the Department of Anesthesia in the hospital, and to make quarterly reports of her cases, consistent with the requirements of the Joint Committee on Accreditation. She was further required to give one "in-service" day in the Obstetrical Department of the hospital in each month, which required her to prepare her lectures and other educational materials for this purpose.

The above duties, many of them outside the hospital, were carried on by petitioner in an office which she maintained in her home. In addition, she used that home office for keeping records of the cases in which she served, billing records with respect to her patients, records of the scheduling of operations involving both herself and other anesthetists whom she recruited, and notes of her preoperative and postoperative interviews with patients regarding their particular requirements for anesthesia. She maintained books and reference materials and tax records in her home office. We find all of this perfectly ordinary and necessary in the case of a self-employed professional such as petitioner, and doubly so in view of the fact that the hospital refused to provide petitioner with any office space.

Respondent argues that petitioner's principal place of business should be held to be the hospital, where she assisted in operations and allegedly earned all her fees, rather than in her home office where, as respondent would have it, no fees were earned, no patients were seen, and only miscellaneous duties were performed.

We find respondent's contentions under the instant circumstances to be without merit. The surgeon in private practice, operating at the hospital, may in the very narrowest sense earn all his fees in the operating room, but he cannot conduct his private practice out of his hip pocket or from a pay telephone down the hall from the operating room. The attorney who confines his practice to litigation may, in the narrowest view, earn all his fees in the courtroom, prosecuting or defending his clients' cases, but he cannot be expected to maintain his practice from the counsel table, or out of the briefcase under his arm. We would not hold that either of those professionals had their "principal place of business" in the operating room or courtroom, respectively, so as to deny them the reasonable costs of their transportation from their offices to the place where they perform their fee-earning services.

So far as this petitioner's office in her home was concerned, the work which she did there, as we have described in our findings of fact, was an integral part of her contract arrangement with the hospital. These included the preparation of in-service lectures and educational materials, the revision of the policy procedure manual for anesthesia, the quarterly reports which petitioner was required to prepare, the scheduling of operations, and the employment of other anesthetists, as necessary. These services, for which there was apparently no direct compensation, were all part of her duties in her position as working head of the Department of Anesthesiology at the hospital. We accordingly have no difficulty in finding that her home office was her principal place of business, in which a substantial part of her work was performed. Wisconsin Psychiatric Services v. Commissioner, supra; Curphey v. Commissioner, supra. The fact that no specific dollar of fee income can be attributed to the work petitioner did in her home office is not determinative under these circumstances. See Adams v. Commissioner, T.C. Memo. 1982-223, affd. without published opinion 732 F.2d 159 (7th Cir. 1984).

We accordingly hold that petitioner's automobile expenses in 1979 and 1980, as stipulated by the parties, are deductible under section 162. Steinhort v. Commissioner, supra; Curphey v. Commissioner, supra; Goodman v. Commissioner, T. C. Memo. 1980-122.

Our disposition of this issue also controls the disposition of the second minor issue in this case. In 1980, it is stipulated that petitioner acquired a new automobile at a cost of $10,000, which she used in traveling between her office and the hospital, to the extent of 90%. Since, as we have held, such travel was business related, it follows that this automobile was an asset used in her trade or business, was depreciable within the meaning of section 167, and therefore qualified as "section 38 property" within the meaning of section 48(a). Petitioner was accordingly entitled to an investment tax credit for the year 1980, the year the automobile was purchased, based upon 90% of the cost thereof, under section 46, in the amount of $300.

Decision will be entered
under Rule 155.

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T. C. Memo. 1986-2

UNITED STATES TAX COURT

GERALD D. BISHOP, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 17691-84. Filed January 2, 1986.

Donald A. Forrest, for the petitioner.

Wesley J. Lynes, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

GOFFE, Judge: The Commissioner determined additions to tax under the provisions of section 6653(b)[1] for the taxable years 1979 and 1980 in the amounts of $9,427.58 and $15,615.56,

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[1] All section references are to the Internal Revenue Code of 1954, as amended, and all rule references are to this Court's Rules of Practice and Procedure.

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respectively. The sole issue before us is whether petitioner is liable for the additions to tax for fraud determined by the Commissioner.[2]

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts and accompanying exhibits are so found and incorporated by this reference.

Gerald D. Bishop (petitioner) resided in West Memphis, Arkansas, at the time his petition was filed. Petitioner was married during the taxable years in issue, but filed separate Federal income tax returns for both years.

Petitioner, who has only an 8th grade education, has been engaged in the business of hauling freight in interstate commerce since 1970 or 1971. He represented other truckers as a truck broker and individually operated two or three trucks. Since 1975 petitioner has operated his business from West Memphis, Arkansas.

During the taxable years in issue petitioner employed John Wilkerson (Wilkerson), a certified public accountant, to handle the bookkeeping and tax return preparation for the business. Periodically, Wilkerson would request, and petitioner would deliver, the information necessary to maintain the books of the business and to prepare the necessary tax returns. Petitioner did not actively assist Wilkerson in the preparation of the tax returns. He has never prepared his own tax returns.

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[2] Petitioner understated his taxable income for the taxable years 1979 and 1980. The deficiencies in Federal income tax for the taxable years 1979 and 1980 have been paid and are not in issue.

During the years in issue, petitioner maintained a checking account with the Bank of West Memphis for use in his business in the name of Bishop Truck Brokerage. On June 8, 1979, petitioner opened a checking account with the First State Bank of Henderson, Tennessee, in the name of Bishop Leasing. On January 21, 1980, he opened another checking account with the Bank of West Memphis, Arkansas, in the name of Haro Trucking. During the taxable years in issue petitioner deposited income from his trucking business in both the Bishop Leasing and Haro Trucking accounts without notifying Wilkerson. Petitioner also paid certain deductible business expenses out of these accounts. Petitioner revealed the existence of the Bishop Leasing account to Wilkerson on April 9, 1981. Wilkerson did not learn of the Haro Trucking account until after the income tax returns for the years in issue had been filed. When he did learn of the Bishop Leasing and the Haro Trucking accounts, Wilkerson understood that they were the personal accounts of petitioner into which no business funds were deposited or withdrawn. Petitioner did nothing to dispel this misconception.

Throughout the years in issue petitioner periodically transferred funds from the Haro Trucking account to the Bishop Truck Brokerage account. Several of the deposit slips representing these transfers included a notation to the effect that the transfers were loans. Petitioner did not advise Wilkerson of the nature of these transfers, but when asked specifically by Wilkerson about one such transfer of $5,000, petitioner acknowledged that this amount represented currently taxable income to his business. He did not advise Wilkerson that other transfers also representing currently taxable income to the business were made.

On May 20, 1980, petitioner received proceeds from an insurance policy in the amount of $48,501.15 for storm damage to his place of business. He deposited this amount in the Haro Trucking account. On the same day, he transfered $12,000 to the Bishop Truck Brokerage account and this amount was subsequently used to pay for repairs to his place of business. Shortly thereafter, he purchased two $10,000 certificates of deposit from the First State Bank of Henderson and one $10,000 certificate of deposit from West Memphis Savings and Loan. He did not inform Wilkerson of the receipt of the insurance proceeds or the purchase of the certificates of deposit until after the income tax returns for the years in issue were filed.

When the certificates of deposit purchased with the insurance proceeds, along with other ones that had been previously purchased, matured, petitioner rolled over the certificates plus accrued interest into new certificates.

Sometime subsequent to the filing of petitioner's Federal income tax returns for the taxable years 1979 and 1980, the Commissioner began to examine those returns. The revenue agent assigned to the audit of the returns contacted Wilkerson to obtain his assistance. During a visit with Wilkerson, the revenue agent presented a document request, which included a request for all of petitioner's "checking accounts, savings accounts and savings certificates." Petitioner was not present at this meeting, but, in the presence of the revenue agent, Wilkerson telephoned petitioner. During this telephone conversation, Wilkerson asked if petitioner had any checking accounts other than the Bishop Truck Brokerage account and if he had any "savings accounts," or words to that effect. Wilkerson did not use the terms "savings certificate" or "certificate of deposit" in his conversation with petitioner. Petitioner gave a negative response. Wilkerson was aware of the Bishop Leasing and Haro Trucking accounts, but, did not inform the revenue agent that they existed.

Two days after presenting the document request to Wilkerson, the revenue agent paid a personal visit to petitioner at his place of business. Prior to this visit the revenue agent had obtained information culled from Forms 1099 filed with the Commissioner by First State Bank of Henderson and West Memphis Savings and Loan reporting interest earned by petitioner on the certificates of deposit. Petitioner had received copies of the Forms 1099 from the two financial institutions and either failed to open them or ignored them.

During his visit with petitioner the revenue agent asked if petitioner had any additional bank accounts or savings accounts or any other savings. Petitioner answered that he did not. At this time the revenue agent confronted petitioner with the interest information obtained from the Forms 1099. Only then did petitioner acknowledge the existence of the certificates of deposit. Petitioner claimed that he did not equate a certificate of deposit with a "savings account." Furthermore, petitioner told the revenue agent that his reason for not reporting the interest income from the certificates of deposit was his belief that he was not obligated to report interest until the certificates were redeemed. Reasonably satisfied with this explanation, the revenue agent told petitioner to gather all of the documentation he had concerning certificates of deposit and savings and checking accounts in preparation for review by the revenue agent. When the revenue agent returned approximately 10 days later petitioner produced the requested documentation, also revealing for the first time the existence of the Bishop Leasing and Haro Trucking checking accounts.

The audit of petitioner's returns for the taxable years 1979 and 1980 resulted in an increase in the income tax liability for each year based upon adjustments for unreported income from the trucking business, unreported interest income, and a decrease in the allowable depreciation deduction based upon the proper capitalization of repair expenditures and reduction of basis due to the receipt of insurance proceeds. Petitioner concurred with the adjustments and paid the additional tax due. Subsequently, the Commissioner issued a statutory notice of deficiency in which he determined that petitioner was liable for additions to tax under section 6653(b).

OPINION

The sole issue before us is whether petitioner is liable for the additions to tax under section 6653(b) for fraud. The burden of proving fraud is on respondent, and he must do so by clear and convincing evidence. Sec. 7454(a); Rule 142(b); Stone v. Commissioner, 56 T.C. 213, 220 (1971). This burden may be met by showing that the taxpayer intended to conceal, mislead, or otherwise prevent the collection of taxes, and that there is an underpayment of tax. Stoltzfus v. United States, 398 F.2d 1002, 1004 (3d Cir. 1968), cert. denied 393 U.S. 1020 (1969); Rowlee v. Commissioner 80 T.C. 1111, 1123 (1983); Acker v. Commissioner, 26 T.C. 107, 112 (1956).

When fraud is determined, as in the instant case, for more than one taxable year, respondent must show that some part of an underpayment was due to fraud for each taxable year for the corresponding addition to tax to be upheld. Professional Services v. Commissioner, 79 T.C. 888, 930 (1982); Nicholas v. Commissioner, 70 T.C. 1057, 1065 (1978); Otsuki v. Commissioner, 53 T.C. 96, 105 (1969). The existence of fraud is a question of fact to be resolved upon a consideration of the entire record. Rowlee v. Commissioner, supra at 1123; Gajewski v. Commissioner, 67 T.C. 181, 199 (1976), affd. without published opinion 578 F.2d 1383 (8th Cir. 1978). Fraud will never be presumed. Beaver v. Commissioner, 55 T.C. 85, 92 (1970). Fraud may, however, be proved by circumstantial evidence because direct proof of the taxpayer's intent is rarely available. Stephenson v. Commissioner, 79 T.C. 995, 1005-1006 (1982), affd. 748 F.2d 331 (6th Cir. 1984); Gajewski v. Commissioner, 67 T.C. at 200. The taxpayer's entire course of conduct may establish the requisite fraudulent intent. Spies v. United States, 317 U.S. 492 (1943); Gajewski v. Commissioner, 67 T.C. at 200; Stone v. Commissioner, supra at 223-224.

As proof of his assertion of fraud, respondent relies on the reticence of petitioner with his accountant and the revenue agent concerning the existence and nature of the Bishop Leasing and Haro Trucking accounts as well as the existence of the certificates of deposit. Misrepresenting facts, failing to inform or otherwise misleading a taxpayer's return preparer or a revenue agent can be persuasive evidence of fraud. Cf. United States v. Newman, 468 F.2d 791, 794 (5th Cir. 1972) (misleading statements to Treasury agents for the purpose of concealing income constitutes a sufficient affirmative act to satisfy sec. 7201); Henry v. Commissioner. T.C. Memo. 1964-170, affd. 362 F.2d 640, 643 (5th Cir. 1966) (hiding bank accounts from revenue agents evidence of fraud).[3] Nevertheless, based on all of the facts and circumstances, we find that respondent did not adequately prove that petitioner fraudulently underpaid income tax. In every instance allegedly demonstrating fraudulent intent there is some plausible nonfraudulent reason for petitioner's actions. Our consideration of these reasons confirms our holding that respondent failed to adduce clear and convincing evidence that petitioner acted fraudulently.

Clearly, petitioner did not provide full and complete information to his tax return preparer. He did not dispel Wilkerson's misconception that the Bishop Leasing and Haro Trucking checking accounts were personal accounts. He also did not inquire as to the proper treatment of the insurance proceeds and the interest earned on the certificates of deposit. However, he explained his failure to tell Wilkerson of the receipt of the insurance proceeds stating that he did not know it was significant in regard to his tax liability. Petitioner also believed that he was not required to report the interest income from the certificates of deposit because the principal and interest on these certificates were rolled over into new certificates.

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[3] Cf. also Estate of Vella v. Commissioner, T.C. Memo. 1982-73 (taxpayer misled revenue agent); Grancich v. Commissioner, T.C. Memo. 1978-92, affd. without published opinion 649 F.2d 867 (9th Cir. 1981) (failure to inform return preparer of extortion income demonstrative of fraudulent intent).

The failure of petitioner to readily reveal the existence of the certificates of deposits when the revenue agent requested all "savings accounts" raises an inference of fraudulent intent. However, based on our review of the record, we believe he may have been merely answering the specific question put to him and no more, suspecting, perhaps, that the agent probably intended for the term "savings accounts" to encompass all manner of savings vehicles.

We agree with respondent that the failure of petitioner to disclose the existence of the Bishop Leasing and Haro Trucking accounts to the revenue agent promptly when asked is evidence of fraud. The belated disclosure of these accounts upon the second visit of the revenue agent does not excuse the earlier misrepresentation. However, it is possible that petitioner failed to disclose the existence of the additional bank accounts to the revenue agent on the assumption that Wilkerson had already done so. Wilkerson knew the accounts existed even if he wrongly understood them to be used by petitioner for personal transactions.

We emphasize that it is not our responsibility to find excuses for the actions or inactions of petitioner. We do not condone much of what he did or failed to do. Petitioner should have been completely forthright with Wilkerson and the revenue agent. Providing full and adequate disclosure of all transactions possibly touching upon a taxpayer's tax liability to a return preparer or other tax advisor, when one is relied upon, is the only way to assure an accurate return of income. It is also desirable, of course, that taxpayers readily assist the Commissioner in audits of returns. Nevertheless, based on our review of the entire record, we find that respondent has not proved by clear and convincing evidence that petitioner fraudulently understated his income for the taxable years 1979 and 1980.

In summary, we have examined the entire record before us and find that respondent has not met his burden of proof. Admittedly, a strong suspicion of fraud might arise from the record before us. However, the standard of proof required of respondent in this case, proof by clear and convincing evidence, is a high one. "[C]ourts will not sustain findings of fraud upon circumstances which at most create only suspicion." Ross Glove Co. v. Commissioner, 60 T.C. 569, 608 (1973). Though it falls short of fraud under section 6653(b), we do not condone petitioner's conduct. Were the issue before us, and particularly in light of the different standard of proof required, we would be inclined to impose the addition to tax for negligence or intentional disregard of rules and regulations under section 6653(a). However, that is not this case.

Decision will be entered for the petitioner.

742-B Ju 11.7/2:1986-3

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T. C. Memo. 1986-3

UNITED STATES TAX COURT

PEARL M. KENNEDY, Petitioner v. COMMISSIONER OF
INTERNAL REVENUE, Respondent

Docket No. 33349-83. Filed January 2, 1986.

Franklin M. Hartzell and Thomas W. O'Neal, for the petitioner.

Matthew J. Fritz, for the respondent.

MEMORANDUM OPINION

WILLIAMS, Judge*: The Commissioner determined a deficiency of $10,528 in gift tax for petitioner's calendar quarter ended June 30, 1979. The sole issue presented to the Court for decision is whether petitioner's disclaimer of an

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* By order of the Chief Judge, this case was reassigned to Judge Williams for decision and opinion.

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undivided one-half interest in property that she had held with her husband jointly with the right of survivorship was a transfer subject to the Federal gift tax. All the facts have been stipulated and are so found.

Petitioner, Pearl M. Kennedy, resided at Hamilton, Illinois at the time her petition was filed in this case. No gift tax return was filed reporting Mrs. Kennedy's disclaimer.

On June 29, 1953, petitioner and her late husband Frank Kennedy acquired 160 acres of farmland as joint tenants with the right of survivorship. Frank furnished all of the consideration for the purchase of the property. The creation of the joint tenancy was never reported as a taxable gift.

Frank died testate on September 27, 1978. The value of the 160 acres was included in Frank's estate and reported on his estate's Federal estate tax return.

On June 21, 1979, petitioner disclaimed an undivided one-half interest in the property. Also on June 21, 1979, petitioner's daughter Marsha M. Froman, who under Illinois law received the disclaimed interest pursuant to the terms of Frank's will, executed a receipt for the interest identified and described in the instrument of disclaimer executed by petitioner. The disclaimer was effective under Illinois law to vest in petitioner's daughter the disclaimed interest.

The parties agree that the value of petitioner's disclaimed interest in the property on June 21, 1979, was $183,400.

The central issue in this case is which event--the creation of the joint tenancy in 1953 or the death of petitioner's husband Frank in 1978--began the period for testing whether the petitioner's disclaimer was timely. If the disclaimer was timely, then no transfer occurred for Federal gift tax purposes. If petitioner did not timely disclaim the interest, then the disclaimer effected a transfer subject to the Federal gift tax.

Petitioner contends that since she received new and valuable property rights upon her husband's death, specifically a fee interest in the entire property, it was his death that commenced the period within which her disclaimer could be made without gift tax consequences. Indisputably, petitioner acquired sole ownership of the property upon her husband's death. Until the death of one joint owner, neither joint owner with a right of survivorship has, by himself, the full enjoyment of the fee interest. In re Estate of Alpert, 95 Ill. 2d 377, 447 N.E. 2d 796 (1983). Indeed, a distinguishing feature of the tenancy held by petitioner and her husband is that sole ownership of the fee is contingent upon the survival of one of the joint tenants, and the Illinois disclaimer law recognizes the survivorship interest as a separate property interest that may be disclaimed after the death of a joint tenant. Ill. Rev. Stat. ch. 30, sec. 211 (1977). This feature is a contingency that is not, however, materially different than the contingency faced by the disclaiming taxpayer in Jewett v. Commissioner, 455 U.S. 305 (1982).

In Jewett, the taxpayer held a contingent remainder interest in a testamentary trust created in 1939. In 1972, prior to elimination of the contingency (i.e. prior to the death of the last surviving life tenant), the taxpayer disclaimed his interest in the trust property. The Supreme Court held that the disclaimer was untimely. To avoid gift tax consequences, the Supreme Court held that the disclaimer should have been made within a reasonable time after the 1939 creation of the trust or, at most, after the taxpayer had attained his majority.

Petitioner's acquisition of additional, valuable property rights in the 160 acres upon the death of her husband was not the transfer that created her interest in the property. The additional property rights acquired upon her husband's death were fixed under Illinois law by reference to her status as a joint tenant with the right of survivorship -- a status that she enjoyed continuously after June 29, 1953. From the creation of the joint tenancy, petitioner had an undivided interest in the entire property. Duncan v. Suhy, 378 Ill. 104, 37 N.E. 2d 826 (1941). Therefore, the "transfer" that began the period for testing the timeliness of the disclaimer of the undivided one-half interest in the property was the creation of the joint tenancy.[1] To hold otherwise would, we believe, contradict the Supreme Court's holding in Jewett that it is not the vesting of an interest or the time the property is possessed that begins the period for testing timeliness, rather it is the creation of petitioner's interest in the property that is the benchmark. Since petitioner's disclaimer of an undivided one-half interest in the property occurred many years after the creation of the joint tenancy that gave her an undivided interest in the whole of the property, her disclaimer was not executed within a reasonable time, sec. 25.2511-1(c), Gift Tax Regs., and effected a transfer of an interest in property subject to the Federal gift tax.

Decision will be entered
for the respondent.

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[1] This determination forecloses petitioner's reliance on sec. 2518 of the Internal Revenue Code as in effect on June 21, 1979, which is applicable to "transfers creating an interest in the person disclaiming made after December 31, 1976." Sec. 2009(e)(2), Pub. L. 94-455, 90 Stat. 1896.

742-B

Ju 11.7/2: 1986-4

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CONTIN

ORIGINAL

T. C. Memo. 1986-4

COMPLETED
8.

UNITED STATES TAX COURT

DAVID E. BRESSLER, Petitioner v. COMMISSIONER
OF INTERNAL REVENUE, Respondent

DARRELL E. WEINGARD, Petitioner v. COMMISSIONER
OF INTERNAL REVENUE, Respondent

Docket Nos. 15386-84, 18397-84. Filed January 6, 1986.

David E. Bressler, pro se.
Darrell E. Weingard, pro se.

Rosabel I. Seigan, for the respondent.

MEMORANDUM OPINION

FAY, Judge: These consolidated cases are before the Court on respondent's motions to dismiss for failure of petitioners properly to prosecute and for damages pursuant to section 6673.[1]

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue. All Rule references are to the Tax Court Rules of Practice and Procedure.

Respondent determined the following deficiencies in and additions to petitioners' Federal income tax:

		Additions to Tax			
Year	Deficiency	Sec. 6651(a)	Sec. 6653(a) or (a)(1)	Sec. 6653(a)(2)	Sec. 6654(a)
Petitioner David E. Bressler					
1979	$6,938	$1,735	$372	-	$283
1980	8,164	2,041	408	-	520
1981	9,010	2,253	451	To Be Computed on an underpayment of $9,010	692
Petitioner Darrell E. Weingard					
1979	2,108	527	105	-	88
1980	2,255	564	113	-	144
1981	2,163	541	108	To Be Computed on an underpayment of $2,163	166

The foregoing deficiencies and additions to tax were based in large part upon respondent's determination that each petitioner had failed to report his distributive share of income from a partnership, BDW Agency.

Each petitioner was a resident of Illinois when he filed his petition herein.[2]

Petitioner Bressler filed his petition in docket No. 15386-84 on May 24, 1984 and respondent filed his answer on July 20, 1984. Although respondent had not raised in his answer any matters as to which he bore the burden of proof, on September 10, 1984, petitioner Bressler filed a "Motion for More Definite

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[2] Petitioner David E. Bressler resided in Cherry Valley, Ill., when he filed the petition in docket No. 15386-84. Petitioner Darrell E. Weingard resided in Rockford, Ill., when he filed the petition in docket No. 18397-84.

Statement" asking that respondent be ordered to provide a more definite statement concerning those matters in his answer as to "which the Commissioner does have the burden of proof." He also filed a "Motion for Jury Trial of Twelve Veniremen" seeking a jury trial. The Court denied these motions on September 14, 1984.

Petitioner Weingard filed his petition in docket No. 18397-84 on June 12, 1984 and respondent filed his answer on August 13, 1984. On October 9, 1984, petitioner Weingard filed a "Motion for More Definite Statement" and a "Motion for Jury Trial of Twelve Veniremen", substantially identical to those filed by petitioner Bressler in docket No. 15386-84. Concurrently therewith, he also filed a "Request for Grant of Immunity" seeking immunity "against the use in any later criminal prosecution, of any financial information he produces as evidence at tax court for any purpose other than to establish a tax liability." The Court denied each of these motions on October 16, 1984.

By means of a Notice Setting Case for Trial, served upon them on January 25, 1984, petitioners were informed that these cases were calendared for trial at the trial session of this Court commencing April 23, 1985 in Chicago, Ill.

In early April 1985, the Court informed each petitioner by letter of the necessity of complying with its Rules, particularly with Rule 91(a), which requires that the parties stipulate all matters as to which agreement can or fairly should be reached. The Court enclosed copies of Rule 91 with its letters. On

April 16, 1985, counsel for respondent forwarded to petitioners a proposed stipulation of facts which, inter alia, allowed deductions to petitioners for certain expenses of BDW Agency which had not previously been allowed in the notices of deficiency.

On April 10, 1985 and April 11, 1985, respectively, less than two weeks prior to the commencement of the trial session, each petitioner filed a motion for continuance.[3] Respondent thereafter filed his objections to these motions, and a hearing thereon was calendared for the commencement of the April 23, 1985 trial session.

When these cases were called on April 23, 1985, petitioners and counsel for respondent appeared. At such time, it became apparent that petitioners had failed to cooperate in the preparation of a stipulation of facts as required by Rule 91(a). Petitioners' motions for continuance were denied. The Court directed petitioners to meet with counsel for respondent concerning the proposed stipulation of facts and indicated that these cases would be recalled on April 25, 1985.

On the afternoon of April 23, 1985 and again on April 24, 1985, petitioners met with counsel for respondent. At these meetings, petitioners produced certain documents and a draft stipulation of facts was prepared. The parties agreed that the stipulation would thereafter be signed in its final form. However, on the morning of April 25, 1985, petitioners informed counsel for respondent that they would not sign the stipulation.

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[3] Rule 134 provides, in part, that a motion for continuance, filed 30 days or less prior to the date to which it is directed, may be set for hearing on that date, but ordinarily will be deemed dilatory and will be denied unless the ground therefor arose during that period or there was good reason for not making the motion sooner.

On April 25, 1985, these cases were recalled subsequent to an in-chambers conference among the Court, petitioners and counsel for respondent. Petitioners persisted in their refusal to sign the stipulation of facts although they could not identify any errors or inaccuracies therein. Petitioners then asserted that they were in possession of certain business check registers which they claimed would show additional deductible expenses. They assured the Court that these business check registers were complete records of relevant transactions. The Court then recessed and advised the parties to meet once again concerning the stipulation of facts and petitioners' check registers. In doing so, the Court warned petitioners that it expected them to conduct these proceedings in compliance with its Rules in an orderly and proper manner.

On the afternoon of April 25, 1985, a further conference was held in chambers, after which these cases were again recalled. At such time, it became evident that the "check registers" which petitioners presented were far from complete records. Petitioners again refused to sign the proposed stipulation of facts. Respondent thereafter moved to dismiss these cases for failure of petitioners properly to prosecute and for the award of damages under section 6673. A hearing was held with respect to respondent's motions on April 30, 1985. At that time, respondent submitted a computation of the deficiencies and additions to tax herein in a reduced amount, giving effect to the items agreed to by respondent as set forth in the proposed stipulation of facts.

First, we consider respondent's motions to dismiss. Rule 123(b) provides as follows:

> Rule 123(b) Dismissal: For failure of a petitioner properly to prosecute or to comply with these Rules or any order of the Court or for other cause which the Court deems sufficient, the Court may dismiss a case at any time and enter a decision against the petitioner. The Court may, for similar reasons, decide against any party any issue as to which he has the burden of proof; and such decision shall be treated as a dismissal for purposes of paragraphs (c) and (d) of this Rule.

In light of petitioners' conduct in this proceeding, particularly their persistent and unjustified refusal to stipulate as required by Rule 91(a), we conclude that dismissal is appropriate. Accordingly, respondent's motions to dismiss will be granted. A decision against petitioners will therefore be entered in the reduced amount as computed by respondent in the motions to dismiss.

Respondent has also moved for damages under section 6673. Under that section, as applicable herein, the Court may award damages to the United States of up to $5,000 when the proceeding has been instituted or maintained by the taxpayer primarily for delay or if the taxpayer's position in such proceeding is frivolous or groundless.

It is evident from the record that petitioners maintained these proceedings primarily for delay. Shortly after the commencement of these cases, petitioners filed documents, such as their motions for more definite statement and for jury trial, strikingly similar to those which we have seen many times in frivolous tax-protestor cases.[4] Despite their awareness in January 1985 that trial of these cases was scheduled for the April 23, 1985 trial session, petitioners filed motions for continuance less than two weeks prior to trial. We considered these to be dilatory and, accordingly, denied such motions.

Prior to the trial session at which these cases were calendared, the Court notified petitioners of their duty to comply with its Rules, particularly Rule 91(a) relating to the stipulation of facts. When this case was first called on April 23, 1985, and it became apparent that petitioners had not heeded the Court's admonition concerning Rule 91(a), the Court again emphasized to petitioners the necessity of complying with the requirements of such Rule. Despite ample opportunity afforded them by the Court to do so, petitioners refused to comply with Rule 91(a) even though they could not identify any errors or inaccuracies in the proposed stipulation of facts.

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[4] Petitioner Weingard also filed a "Request for Grant of Immunity," also similar to those often filed in cases involving tax protestors.

After recalling the cases on April 25, 1985, this Court again recessed these proceedings so that petitioners could have the opportunity to produce their "business check register" and to meet with respondent's counsel concerning the proposed stipulation of facts. When the cases were again recalled on April 25, 1985 it became evident that, contrary to their representations, petitioners' business check register was not a complete record of transactions. Petitioners again persisted in their unjustified refusal to sign the stipulation of facts.

Petitioners are intelligent, college-educated individuals. In view of their conduct and attitude of noncooperation herein we are convinced that they maintained these proceedings, not in a good faith effort to resolve a legitimate dispute with respondent but, rather, primarily to delay the payment of their Federal income tax liabilities. Accordingly, we award damages in the amount of $5,000 against each petitioner, i.e. $5,000 in docket No. 15386-84 and $5,000 in docket No. 18397-84.

To reflect the foregoing,

Appropriate orders
and decisions will be entered.

742-B

Ju 11.7/2:1986-5

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ORIGINAL

T. C. Memo. 1986-5

COMPLETED
12.

UNITED STATES TAX COURT

TERRY COLTON, Petitioner v. COMMISSIONER OF
INTERNAL REVENUE, Respondent

Docket No. 17533-84. Filed January 6, 1986.

Terry Colton, pro se.

Blake W. Ferguson, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

COHEN, Judge: Respondent determined deficiencies in and additions to petitioner's Federal income taxes as follows:

		Additions to Tax		
Year	Deficiency	Sec. 6651(a)[1]	Sec. 6653(a)(1)	Sec. 6653(a)(2)
1980	$6,188.00	$	$309.40	
1981	9,162.00	775.00	458.10	*

*Amount to be determined.

After concessions, the issues for decision are whether petitioner had unreported income, whether he is entitled to deductions in relation to rental of space in his residence, and whether he is liable for additions to tax for negligence and for late filing of his 1981 return.

FINDINGS OF FACT

Petitioner was a resident of Wasilla, Alaska, at the time he filed his petition herein. During the years 1980 and 1981, he was employed by Otis Engineering Corporation, conducted a photography business, and owned rental property in Omaha, Nebraska, and Battle Lake, Minnesota. Losses from the photography business were reported on Schedules C to his returns, and losses from the real property rentals were reported on Schedules E to his returns.

On his returns for 1980 and 1981, petitioner claimed deductions of $10,073 and $15,874, respectively, for contributions to the Universal Life Church. During the years in issue, petitioner maintained a bank account in the name of Universal Life Church as well as several bank accounts in his own name. Deposits into and disbursements from the account maintained in the name of the church related primarily to maintenance of a large house occupied by petitioner and by various other persons at different times during the years in issue. The persons occupying the house from time to time made contributions to the expenses of maintaining the house, groceries, and automobile expenses. The amounts paid by persons other than petitioner were not based solely on periodic costs but were based in substantial part on the person's ability to pay, if any.

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[1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue.

Petitioner's willingness to provide housing for various individuals without charging a specified amount as rent was based on his experience when he first arrived in Alaska without assets or employment. Petitioner was assisted by one or more individuals until he established himself, and, consistent with a tradition in Alaska,[2] resolved that, when he was able to do so, he would assist others who came to Alaska under similar circumstances.

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[2] Petitioner invites the Court to return to Alaska to observe that petitioner's operations with respect to his house are consistent with normal practices in that state. We accept petitioner's representations in this regard. See J. McPhee, "Coming Into the County" 6th ed. (1981). The tax consequences of the activity, however, depend on application of the statutes, not approval or disapproval of petitioner's lifestyle.

Petitioner's return for 1981 was signed by him on or about April 8, 1982, and returned to his preparer for handwritten corrections and mailing. The return was stamped received by the Internal Revenue Service on June 25, 1982. No extension of time for filing the return was obtained.

Respondent examined petitioner's returns for 1980 and 1981 and, based on analysis of petitioner's bank accounts, determined that he had additional income of $10,898 in 1980 and $7,592 in 1981. Respondent also determined that, in 1980, petitioner had additional interest income of $104 and income of $325 from a state tax refund. Respondent disallowed the contribution deductions claimed with respect to the Universal Life Church.

At the time of trial, petitioner conceded that he had additional interest income in the amount determined by respondent and that he was not entitled to the deductions claimed for contributions to the Universal Life Church. Respondent conceded that petitioner did not have income in 1980 from a state tax refund. Petitioner then claimed that most of the unexplained deposits determined by respondent to be additional income were income from nontaxable reimbursements or rents paid by the other occupants of his house and that such rents were more than offset by expenses relating to the house. Petitioner presented proposed amended Schedules E showing purported losses from rental of the house, assuming 75 percent rental use, of $6,346 in 1980 and $9,046 in 1981.

OPINION

Petitioner has the burden of proving that respondent's determination is incorrect as to the amount of the deficiencies and the additions to tax, and he must also establish that he is entitled to the additional deductions that he claims. Welch v. Helvering, 290 U.S. 111 (1933); New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934); Bixby v. Commissioner, 58 T.C. 757 (1972); Rule 142(a), Tax Court Rules of Practice and Procedure.

During trial, petitioner described the manner in which he conducted his home as a "boarding house" and identified to respondent's satisfaction some nontaxable reimbursements reflected in the bank deposits analysis used by respondent to determine that petitioner had unreported income. After trial, the parties reached further agreement on some items, thereby reducing the amount remaining in dispute. Respondent now contends that the unreported income reflected in the bank deposits analysis is $5,722.21 for 1980 and $4,991.83 for 1981. Respondent contends that petitioner has not shown that he overcomes section 262, or is not limited to the amount of deductions authorized under sections 183 and 280A.

Petitioner claims that three-fourths of his residence was rented to tenants and that the tenants should be distinguished from "guests" who were allowed to stay with little or no charge. Petitioner's post-trial assertions in his brief, however, are not supported by his testimony at trial and are inconsistent with his

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earlier claims that the home was operated as a church. In an addendum sheet to his petition, for example, petitioner asserted that the amounts originally claimed as contributions to the Universal Life Church were "charity for the purpose of helping the homeless, feeding the hungry, employing the unemployed, and otherwise providing assistance when and where help was needed * * *." Petitioner's later attempt to reclassify for tax purposes the costs of his home is accompanied by the claim that as a "landlord," he was providing food, an automobile, and "atmosphere" to his "tenants."

The taxpayer generally may deduct ordinary and necessary expenses paid or incurred in carrying on a trade or business or for the management, conservation, or maintenance of property held for the production of income. Sections 162(a), 212(2). To qualify for deductions under either section 162(a) or section 212(2), the taxpayer must have engaged in the activity with an actual and honest profit objective. See Dreicer v. Commissioner, 78 T.C. 642, 646 (1982), affd. without opinion 702 F.2d 1205 (D.C. Cir. 1983); Jasionowski v. Commissioner, 66 T.C. 312, 319-324 (1976). Thus no deduction generally is allowable for personal, living, or family expenses. Section 262. Profit objective is a question of fact to be determined from all the facts and circumstances, and greater weight is to be given to the objective facts than to a mere declaration of the taxpayer's intent. Section 1.183-2(a), Income Tax Regs.; Engdahl v. Commissioner, 72 T.C. 659, 666 (1979).

Congress concluded, however, that the general "facts and circumstances" test was inadequate for determining the deductibility of expenses associated with a home used for both rental and personal purposes. Congress therefore enacted section 280A in the Tax Reform Act of 1976, Pub. L. 94-455, sec. 601, 90 Stat. 1525, 1569. Section 280A provides definitive rules for the deduction of such expenses. See H. Rept. No. 94-658 (1975), 1976-3 C.B. (Vol. 2) 695, 854-856; S. Rept. No. 94-938 (1976), 1976-3 C.B. (Vol. 3) 49, 188-190.

Section 280A(a) provides the general rule that no deduction is allowable "with respect to the use of a dwelling unit which is used by the taxpayer during the taxable year as a residence." Subsection (c) of section 280A lists exceptions to the general rule. The exceptions include "any item which is attributable to the rental of the dwelling unit or portion thereof (determined after the application of subsection (e))." Subsection (e) requires a taxpayer who uses the dwelling unit for personal purposes during the taxable year, as a residence or otherwise, to limit his deductions for expenses other than those otherwise allowable (such as mortgage interest and taxes) to the amount determined after applying the percentage obtained by comparing the number of days the unit (or portion thereof) is rented at a fair rental to the total number of days the unit (or portion thereof) is used. Bolton v. Commissioner, 77 T.C. 104 (1981), affd. 694 F.2d 556 (9th Cir. 1982). Paragraph (5) of section 280A(c) further limits deductions for rental use of a residence to the excess of the gross rental income over the portion of the otherwise allowable expenses that are attributable to the rental use. In other words, any net rental loss cannot be offset against unrelated income. This latter limitation operates analogously to section 183(b), which allows certain deductions for expenses in relation to an activity not engaged in for profit. H. Rept. No. 94-658, supra, 1976-3 C.B. (Vol. 2) at 857; S. Rept. No. 94-938, supra, 1976-3 C.B. (Vol. 3) at 191.

To be entitled to any deductions, either against unrelated income or as an offset to amounts received from persons residing in the house with him, petitioner must satisfy the conditions of the above sections. We conclude that he has not done so.

The record indicates that petitioner's home constituted a single "dwelling unit" as defined in section 280A(f)(1),[3] which petitioner "used as a residence" as defined in section 280A(d).[4] Petitioner contends that tenants occupied three of four "apartments" in the house, but his description of the physical layout of the residence is vague. His testimony in this regard is notably uncorroborated by any tenant or other witness, and, from the absence of corroboration, we infer it does not exist. See Wichita Terminal Elevator Co. v. Commissioner, 6 T.C. 1158 (1946), affd. 162 F.2d 513 (10th Cir. 1947). The facts do not justify the conclusion that petitioner used any portion of his home exclusively as a "hotel, motel, inn, or similar establishment." Therefore, any deductions associated with

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[3]

> (1) Dwelling Unit Defined.--For purposes of this section--
>
> (A) In general.--The term "dwelling unit" includes a house, apartment, condominium, mobile home, boat, or similar property, and all structures or other property appurtenant to such dwelling unit.
>
> (B) Exception.--The term "dwelling unit" does not include that portion of a unit which is used exclusively as a hotel, motel, inn, or similar establishment.

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[4] (d) Use as Residence.--

(1) In general.--For purposes of this section, a taxpayer uses a dwelling unit during the taxable year as a residence if he uses such unit (or portion thereof) for personal purposes for a number of days which exceeds the greater of--

(A) 14 days, or

(B) 10 percent of the number of days during such year for which such unit is rented at a fair rental.

For purposes of subparagraph (B), a unit shall not be treated as rented at a fair rental for any day for which it is used for personal purposes.

(2) Personal Use of Unit.--For purposes of this section, the taxpayer shall be deemed to have used a dwelling unit for personal purposes for a day if, for any part of such day, the unit is used--

(A) for personal purposes by the taxpayer or any other person who has an interest in such unit, or by any member of the family (as defined in section 267(c)(4)) of the taxpayer or such other person;

petitioner's rental of his home are subject to the limitations of subsections (e) and (c)(5) of section 280A.

Although petitioner asserts that rents were paid on the basis of fair market value, he has provided no independent evidence of fair market value or even specific testimony as to the identity of the tenants and the contractual relationships with them. In light of petitioner's pre-trial position in this case, we cannot accept his uncorroborated assertions. Subsection (e) thus limits petitioner's deductions to expenses that are "otherwise allowable."

We are similarly unpersuaded by petitioner's belated assertions that he was engaged in a rental activity for profit. His original claims of charitable intent and his description of the living arrangements at his residence are more consistent with a good-natured sharing arrangement, based on a need for companionship and a desire to abide by the Golden Rule, i.e., to do under others as was done for him.

Having carefully reviewed the record, including petitioner's explanation and respondent's concession as to many of the previously unexplained deposits, we conclude that, to the extent otherwise unexplained, substantially all of the deposits were "rent" for the use of his dwelling. On his tax returns for the years in issue, petitioner claimed itemized deductions as follows:

	1980	1981
Home Mortgage Interest	$6,442	$5,559
Real Estate Taxes	741	525
Total	$7,183	$6,084

If we assume that petitioner is entitled to claim 75 percent of the above expenses as attributable to rental of his home, amounts recharacterized and deducted against rental receipts ($5,722.21 in 1980 and $4,991.83 in 1981) would be $5,387 in 1980 and $4,563 in 1981. Petitioner's personal itemized deductions would be reduced by the amounts recharacterized.

Because his original return claimed improper deductions for contributions to the Universal Life Church, the additions to tax for negligence will be sustained. See Hall v. Commissioner, 729 F.2d 632, 635 (9th Cir. 1984); Davis v. Commissioner, 81 T.C. 806 (1983), affd. in an unpublished opinion 767 F.2d 931 (9th Cir. 1985).

With respect to the addition to tax for late filing of his 1981 return, petitioner speculates that an error in reflecting the date of receipt was made by an employee of the Internal Revenue Service. Although the scenario that petitioner hypothesizes is not impossible, it is unlikely, and there is no reason to believe that it happened in this case. The only conclusion supported by the evidence is that petitioner delivered the tax return to his preparer for correction and mailing, and the preparer failed to timely mail the return. Even if petitioner relied in good faith on his preparer to mail the return, he must bear the consequences of the late filing. United States v. Boyle, 469 U.S. ___, 105 S. Ct. 687 (1985).

Decision will be entered under Rule 155.

742-B

Ju 11.7/2:1986-6

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T. C. Memo. 1986-6

UNITED STATES TAX COURT

CHARLES A. BAGLEY, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 2018-84. Filed January 7, 1986.

Charles A. Bagley, pro se.

Dennis Perez, for the respondent.

MEMORANDUM OPINION

AARONS, Special Trial Judge: This case was assigned to Special Trial Judge Aarons pursuant to section 7456(d)(3) and Rules 180, 181 and 182[1]. The case was calendared for trial at the October 28, 1985 trial calendar in Los Angeles. Petitioner failed to appear.

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[1] Section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated. Rule references are to the Tax Court Rules of Practice and Procedure.

ORIGINAL

Respondent determined deficiencies in petitioner's Federal income taxes together with additions as follows:

		Additions to Tax	
Year	Deficiency	Sec. 6653(b)	Sec 6654(a)
1974	$ 982.00	$491.00	$31.42
1975	1,481.00	740.50	63.96
1976	958.00	479.00	35.68

Petitioner filed a timely petition herein at which time he resided in Burbank, California. The petition contained no facts suggesting that the income items determined in the Notice of Deficiency were not actually realized in the years at issue. The petition asserts that petitioner was not a "taxpayer" having "neither paid or overpaid any Internal Revenue Tax voluntarily" and requests a speedy determination on that ground of this Court's jurisdiction. The petition further sets forth petitioner's awareness of the Court's authority to award damages up to $5,000 for frivolous petitions and requests that if it is the Court's intention to declare the petition frivolous, the Court should promptly reject the petition and return the filing fee.

The petition then proceeds to recite the familiar protester-type allegations closely similar in wording to the hundreds of other petitions filed by persons in the Southern California area. The petition alleges that the Notice of Deficiency may be "Crimen Falsi"; that the Secretary of the Treasury, and his agents, have no authority to assess the tax;

that there was no Code requirement for the filing of returns by petitioner; that section 6211, defining "deficiency", does not apply; that petitioner did not volunteer to assess himself; and that petitioner received nothing of tangible value during the years at issue and enjoys no privilege or franchise.

Petitioner filed a motion for a jury trial, which the Court denied. Petitioner later filed several documents in which he attempted to withdraw his petition. The Court treated these as motions to dismiss, and denied the motions.

With leave of the Court, respondent filed an Amendment to Answer alleging that petitioner fraudulently failed to file returns for the years at issue; that he fraudulently failed to report the taxable income and tax set forth in the Notice of Deficiency; that his failure to file returns for those years is part of a three-year pattern of intent to avoid taxes; that he filed with his employer, with fraudulent intent, improper W-4E forms in each of the years certifying that he anticipated no tax liability in those years and caused his employer not to withhold Federal income tax; that he fraudulently certified to his employer in 1974 that he had no income tax liability for 1973 when in fact he had incurred a joint income tax liability of $891 for 1973; and that he failed to produce records required by respondent, and that such failure was fraudulent and with intent to evade taxes.

Petitioner filed no reply to respondent's affirmative allegations in the Amendment to Answer. Respondent timely moved, under Rule 37(c), to have those allegations deemed admitted. The Court set the Calendar Call date as the time for petitioner to respond to that motion. In default of any appearance by petitioner on that date, the Court granted respondent's motion under Rule 37(c).

With respect to petitioner's requests which pertain to our jurisdiction and our pre-determination as to the frivolousness of the petition, the Court has already rejected this procedural "sleight of hand" device. See Fox v. Commissioner, T.C. Memo. 1984-519; see also Wright v. Commissioner, T.C. Memo. 1985-103 and cases cited therein to the effect that there is no provision for special appearance in the United States Tax Court, and that a petition, once filed, cannot be withdrawn without prejudice.

Petitioner's allegations in his petition are similar to those filed in hundreds of similar cases in Southern California. See, e.g., Hughes v. Commissioner, T.C. Memo. 1985-138; Allen v. Commissioner, T.C. Memo. 1985-329 and cases cited therein. Petitioner's allegations are utterly dilatory, frivolous and groundless. Rowlee v. Commissioner, 80 T.C. 1111(1983). In addition, by failing to respond to the calendar call, petitioner has subjected his case to dismissal under Rule 123 (failure to prosecute) and Rule 149 (failure to adduce evidence). Based upon this record we sustain respondent's determination of deficiencies and additions under section 6654(a).

With respect to the addition to tax for fraud, under section 6653(b), the burden of proof is on respondent (Rule 142(b)), and he must carry that burden by clear and convincing evidence. Doncaster v. Commissioner, 77 T.C. 334, 336 (1981). The allegations in respondent's Amendment to Answer, which are deemed to be admitted under Rule 37(c), may satisfy respondent's burden of proof. Doncaster v. Commissioner, supra at 337. Here the deemed-admitted allegations clearly carry respondent's burden of proof. Petitioner filed false W-4E forms with his employer for each of the years at issue; he filed no returns for those years although he had filed at least for the year preceeding the first year at issue; he had taxable income in each year at issue and despite his knowledge of reporting procedures, he paid no tax for such years. These acts and omissions were fraudulent and with intent to evade tax. Petitioner was given ample opportunity to reply to the affirmative allegations of the Amendment to Answer. He chose not to do so. He could have been heard had he so wished. He chose to remain silent.

Upon consideration of the entire record (see Gajewski v. Commissioner, 67 T.C. 181, 199 (1976), affd. without published opinion 578 F.2d 1383 (8th Cir. 1978)), we find that respondent has established fraud for each year in issue, and that petitioner is liable for the additions to tax for fraud under section 6653(b) in the amounts determined by respondent.

As to damages pursuant to section 6673, petitioner in his petition raises only worn-out, meritless arguments. He, of course, has every right to contest respondent's determination of fraud. But, petitioner's course of conduct convinces us that he did not come before this Court in order to challenge the fraud determination. His failure to prosecute his case coupled with the clearly frivolous petition convinces us that petitioner's primary purpose was not to utilize this Court as a forum to litigate a genuine tax controversy, but only to express his dissatisfaction with the Federal income tax system and to delay the payment of his Federal tax obligations.

Consequently, upon a review of this record, we conclude that this proceeding was instituted and maintained primarily for delay and that petitioner's position in this proceeding as to the underlying deficiencies was frivolous and groundless. We accordingly award damages to the United States in the amount of $3,000.

An appropriate order and
decision will be entered.

742-B Jue 11.7/2:1986-7

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T. C. Memo. 1986-7

UNITED STATES TAX COURT

GERARD H. MADAN AND DOROTHY M. MADAN, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 5072-80. Filed January 7, 1986.

James E. Merritt, for the petitioners.

Frank D. Armstrong, Jr., for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

SHIELDS, Judge: Respondent determined a deficiency in petitioners' Federal income tax of $5,183.05 for the taxable year 1976. The only issue is whether petitioners converted their former residence into property held for the production of income for computing a loss under section 165[1] and depreciation under section 167 and, if so, the amount of the loss and the depreciation they are entitled to deduct.

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[1] All section references are to the Internal Revenue Code of 1954, as amended, in effect during the year in issue. All Rule references are to the Tax Court Rules of Practice and Procedure.

ORIGINAL

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and attached exhibits are incorporated herein by reference.

Petitioners, Gerard H. MaDan and Dorothy M. MaDan, husband and wife, resided in Hickory, North Carolina, at the time of the filing of their petition. They filed a joint income tax return for the taxable year 1976 with the Internal Revenue Service at Greensboro, North Carolina.

Petitioners' personal residence was at 556 Third Street, Hickory, North Carolina prior to April 1974, when they moved to a house they had just constructed on Lake Hickory, North Carolina. They occupied the Lake Hickory house as their principal residence until sometime in September 1974 when, being pressed for the repayment of the personal loans used to finance the construction of the Lake Hickory house, they moved back into their former residence at 556 Third Street and listed the Lake Hickory residence for sale. The total cost to petitioners of the Lake Hickory house including the lot on which it was located was $66,817.94. They originally listed it for sale at $67,500.

In November 1974, petitioners terminated the listing and allowed the house to be occupied by Jack Lance and his wife. At that time Lance was an employee in petitioners' commercial photography business and he and his wife were actively negotiating with petitioners with respect to a possible purchase of both the business and the Lake Hickory property. During their occupancy of the Lake Hickory house, the Lances paid no fixed monthly rent but did pay the utilities and a few incidental expenses for maintenance.

About the end of February 1975, negotiations between petitioners and the Lances for the sale of the business and the Lake Hickory property fell through and Mr. Lance's employment with petitioners was terminated. Petitioners demanded that the Lances leave the Lake Hickory property and pay rent at $300 per month for the period of their occupation. The Lances left the house but refused to pay the rent demanded by petitioners.

After the Lances left the house, petitioners in 1975 listed it for sale or rent with two different brokers. In January 1976, petitioners listed the house for sale or rent with still another broker. Through the efforts of this broker, petitioners finally sold the house in June 1976 and their net proceeds after selling expenses totaled $46,858.20. The house was not occupied from the time the Lances moved out until it was sold.

On their 1976 tax return, petitioners claimed a deduction of $17,632.64 for the loss on the sale of the house. They also claimed a deduction of $705 for depreciation. Respondent disallowed both deductions in their entirety.

OPINION

The parties agree that from April to September of 1974 the Lake Hickory property constituted the petitioners' personal residence. They disagree, however, as to whether it was thereafter converted by petitioners into property held for the production of income.

Petitioners contend that they qualify to deduct the loss on the sale of the property under section 165 and to deduct depreciation under section 167 because in November 1974 they "converted the Lake Hickory house from a personal residence to an income-producing property" and the conversion of the property is evidenced by the fact that for "almost two years thereafter [until June 1976 when the property was sold] they rented or tried to rent" the house.

Respondent contends that petitioners' offers to rent the house do not establish that it was converted to income-producing property and that under the circumstances of this case, the occupancy of the residence by the Lances did not constitute a conversion of the residence to rental property.

Under section 165,[2] petitioners are entitled to deduct their loss on the sale of the house if the loss was incurred in a transaction entered into for profit. Under section 167,[3] they are entitled to a deduction for depreciation if the house was held for the production of income.[4]

A loss on the sale of a taxpayer's personal residence is not deductible under section 165. However, if the use of the house as his personal residence is terminated and thereafter the property is subjected to some transaction which is profit inspired, then the loss is deductible. Grammer v. Commissioner, 12 T.C. 34 (1949).

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[2] Section 165 provides in part as follows:

> (a) General Rule.--There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.
>
> * * *
>
> (c) Limitation on Losses of Individuals.--In the case of an individual, the deduction under subsection (a) shall be limited to--
>
> (1) losses incurred in a trade or business;
>
> (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business * * *.

[3] Section 167 provides in part as follows:

> (a) General Rule.--There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)--
>
> (1) of property used in a trade or business, or
>
> (2) of property held for the production of income.

[4] Petitioners do not contend that the deductions were incurred in a trade or business.

The determination of whether a personal residence has been converted to property held for the production of income so as to qualify for depreciation under section 167 depends upon "the purpose or intention of the taxpayer in light of all of the facts and circumstances." Newcombe v. Commissioner, 54 T.C. 1298, 1303 (1970). In making such a determination, the following factors have been considered: (1) whether the house was occupied by the taxpayer as a personal residence for a substantial period of time; (2) whether the house was occupied during the period between its abandonment as a residence and its ultimate sale or other disposition; (3) whether the property has a recreational character; (4) whether bona fide offers for rent are present; and (5) whether offers for sale are present. Newcombe v. Commissioner, supra at 1300-1301; Quinn v. Commissioner, 65 T.C. 523, 526 (1975).

Petitioners insist that they qualify under both section 165 and section 167 by their conversion of the residence to rental property in November 1974. They have the burden of proving that an appropriate conversion occurred. Jasionowski v. Commissioner, 66 T.C. 312 (1976). See also Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a).

It is agreed that petitioners abandoned the house as their personal residence in September of 1974 and listed the property for sale. It is also agreed that from November 1974 to February 1975 the Lances resided in the house, that while they resided in the house the Lances paid only the utilities plus a few incidental expenses of maintenance, and that during all or a part of this time Mr. Lance was negotiating with petitioners with regard to a possible purchase of the house as well as a possible purchase of petitioners' business in which he was employed.

There is disagreement as to the terms upon which the house was occupied by the Lances. Petitioner, Gerard H. MaDan, testified that there was an oral agreement between him and Mr. Lance to the effect that the Lances would pay rent in the amount of $300 per month. To the contrary, Mr. Lance testified that there was no agreement with respect to a fixed monthly rental. Instead, according to his testimony, he and his wife were permitted by petitioners to live in the house from November 1974 to February 1975 in return for the payment of only the utilities and maintenance expenses. Mr. Lance further testified that it was his understanding that petitioners permitted them to move into the house under this very favorable arrangement because: (1) Mrs. MaDan was upset when she learned that the Lances were living in an old house which had cost only $8,000 and which was in very poor condition; (2) petitioners wanted someone in the Lake Hickory house to look after the property and to keep an eye on their daughter who lived next door; and (3) petitioners thought that by permitting the Lances to live in the house under such favorable terms, petitioners would enhance their chances of successfully negotiating a sale of the house and/or their photography business to the Lances. Mr. Lance did admit that when the negotiations regarding a possible purchase by the Lances terminated, Mr. MaDan unsuccessfully demanded that the Lances pay rent in the amount of $300 per month for the entire period of their occupancy.

From a consideration of the record as a whole, and especially the fact that while the Lances were living in the house they were admittedly being considered by petitioners as possible purchasers of the house and the business, we believe that Mr. Lance's recollection of the circumstances is substantially more plausible than that of Mr. MaDan. Furthermore, Mrs. MaDan failed to appear as a witness which supports an inference that her testimony if offered on this point would have been unfavorable to petitioners. Wichita Terminal Elevator Co. v. Commissioner, 6 T.C. 1158 (1946), affd. 162 F.2d 513 (10th Cir. 1947). We conclude, therefore, that the occupancy of the Lake Hickory house by the Lances was not pursuant to a bona fide rental agreement but instead was part of petitioners' efforts to sell the house or the business to the Lances and, consequently, cannot be considered as any evidence that petitioners had converted the house to rental property.

Subsequent to the departure of the Lances, petitioners listed the property with three different realtors. The listings, however, were for sale or rent and even if exclusively for rent would not be sufficient to establish a profit motive. See Grammer v. Commissioner, 12 T.C. 34 (1949); Horrmann v. Commissioner, 17 T.C. 903, 909 (1951); and Wilson v. Commissioner, 49 T.C. 406, 415 (1968), revd. and remanded on other grounds, 412 F.2d 314 (6th Cir. 1969). In the absence of an actual bona fide rental, the listings are not sufficient. Heiner v. Tindle, 276 U.S. 582 (1928); sec. 1.165-9(b)(1), Income Tax Regs.

In view of all the foregoing, we conclude that petitioners have failed to carry their burden of proving that prior to its sale the residence was converted to rental property. In fact, from the record as a whole it is readily apparent that from the time they abandoned the property as their personal residence in September 1974 until it was sold in June 1976, they were primarily holding it for sale and not for the production of income through rents. This includes the period during which the property was occupied by the Lances who, in our opinion, were not tenants but prospective purchasers. Therefore, petitioners do not qualify to deduct the loss on the sale or depreciation on the house.

Inasmuch as we have found that petitioners are not entitled to such deductions, we need not consider the other issues raised by the pleadings.

Decision will be entered
for respondent.

742-B Ju 11.7/2:1986-8

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T. C. Memo. 1986-8

UNITED STATES TAX COURT

AUGUSTO P. RODRIGUEZ AND MARGARITA RODRIGUEZ, Petitioners
v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 26369-83. Filed January 8, 1986.

Luis Medina, for the petitioners.

Claudine Ryce, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

FEATHERSTON, Judge: Respondent determined deficiencies in petitioners' Federal income taxes and additions to tax as follows:

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Year	Deficiency	Addition to Tax Sec. 6653(b), I.R.C. 1954	Addition to Tax Sec. 6653(a), I.R.C. 1954
1976	$ 96,493.00	$48,247.00	-0-
1977	$108,883.00	$54,441.50	-0-
1978	$144,940.00	$72,470.00	-0-
1979	$ 12,953.14	-0-	$648

The issues for decision are as follows:

1. Whether respondent erred in his determination of petitioners' taxable income for 1976, 1977, and 1978 by using the net worth increase and nondeductible expenditures method of income reconstruction;

2. Whether any part of the underpayment of petitioners' income tax for 1976, 1977, and 1978 was due to fraud within the meaning of section 6653(b),[1] and

3. Whether any part of petitioners' underpayment of tax for 1979 was due to negligence or intentional disregard of the tax laws within the meaning of section 6653(a).

FINDINGS OF FACT

1. General

Petitioners Augusto P. Rodriguez (hereinafter petitioner) and Margarita Rodriguez (sometimes hereinafter referred to as Margarita or petitioner's spouse), husband and wife, were legal residents of Miami, Florida, when they filed their petition. They filed joint Federal income tax returns for 1975 through 1979, reporting all income and deductions on the cash receipts and disbursements method of accounting.

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[1] All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise noted.

Petitioner was born in 1934 in Cuba and lived in that country until late 1968, when he moved to Madrid, Spain. Petitioner remained in Spain for approximately 2-1/2 years. He then entered the United States at Miami, Florida, as a resident alien. He and his present wife, Margarita, have three children. He became a United States citizen in 1976 and Margarita became a citizen in 1978.

2. Organization of Almacen El Espanol

As a result of the severance of diplomatic relations between the United States and Cuba, United States residents were not permitted to send money, clothing, medicine, or other items to friends or relatives in Cuba. Moreover, Cuban residents were not permitted to fly directly to the United States. On his arrival in the United States from Spain in 1971, petitioner began a business, which continued through the years here in controversy, under the name Almacen El Espanol. The business involved primarily the preparation and processing of the legal paperwork for persons who wished to leave Cuba either by way of Spain or Jamaica for permanent or temporary stays in the United States. In addition, the business involved the freight forwarding of medicine, clothing, and other items to Cuba via Spain, Mexico, or Canada. Petitioner received referrals of potential customers from affiliates in several locations in the United States, including New Jersey, Illinois, California, and Maryland.

Petitioner had the business incorporated on April 8, 1976, under the name of Almacen El Espanol, Inc. (Almacen or the corporation). The corporation adopted a fiscal year ending April 30. For the fiscal years ended April 30, 1977, and April 30, 1978, Almacen reported its income as a regular or subchapter C corporation. For the fiscal year ended April 30, 1979, Almacen was taxable as a subchapter S corporation and its stock was owned by petitioner with 60 percent, Margarita with 20 percent, and Carmen Ordenes, petitioner's daughter from a prior marriage, with 20 percent. Petitioner made all the business decisions.

For its services during 1976, 1977, and 1978, Almacen charged fees of $59 to send money to individuals in Cuba for the purchase of airline tickets. Almacen also charged substantial fees for shipping to Cuba packages of clothing, medicine, and other articles. It charged its customers fees of $175 per person for doing the paperwork necessary to bring people to the United States for visits. To be permitted to land in Jamaica on the way to the United States, the Cubans were required to have at least $300 in cash. Almacen collected deposits of the required cash from its customers to cover the Jamaican entry fees and charged a fee of $59 for the transmittal and delivery of each $300 to Jamaica.

3. The Corporate and the Customer Deposits Bank Accounts

When Almacen was organized, petitioner's accountant, Ruben Garcia (Garcia), suggested that the corporate receipts should be deposited into two separate accounts. In one account (hereinafter the corporate account),[2] the fees for services would be deposited, and the corporation would include these amounts in its gross income. In the other account (hereinafter the customer deposits account)[3] the customer deposits of funds received for transmittal to Jamaica would be placed. Funds deposited in this account were to be held as nontaxable trust funds.

During 1976, 1977, and 1978, Almacen maintained a corporate bank account at the Sun Bank of Miami.[4] In this corporate account, Almacen deposited most of the fees that it received from its customers for its services and drew checks on the account to cover Almacen's payroll and other expenses. The deposits in this corporate account and the checks drawn on it were used as the basis for computing Almacen's taxable income for income tax purposes.

During 1976, 1977, and 1978, petitioners maintained in their own names the customer deposits account at the Sun Bank of Miami,

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[2] This account is referred to in the record by various names: general account, general operating account.

[3] This account is referred to in the record by various names: deposit account, special account, escrow account, and reimbursement account.

[4] From the beginning of 1976 to Nov.3 of that year, the account was designated number 417927 and was thereafter designated as 014349.

No. 20-522-0. In this account, petitioner placed most of the funds received from customers for transmittal to Jamaica for use in enabling friends and relatives (clients) of Almacen's customers to land in Jamaica on their way to this country. In some instances, petitioner deposited in this account fees received from customers for sending packages to Cuba, thereby diverting to this account fees which, under the accounting system recommended by Garcia, should have been treated as corporate income. Petitioners did not pay taxes on deposits in this account. In other instances, Margarita deposited in her personal accounts or that of her minor daughter, Twinky, checks payable to Almacen as fees or deposits.

Some of the individuals for whom deposits were made did not enter the United States through Jamaica. The receipt form used by Almacen for the deposits did not indicate that a refund of deposited amounts would be made in any circumstances. When a customer demanded a refund, it was made but usually in a discounted amount, purportedly on account of the devaluation of the Jamaican dollar even though the money remained in the United States at all times; the discounts averaged approximately 20 percent. No interest was paid on any refunds. No refunds were made unless they were demanded. Petitioners did not return to Almacen the deposits for which refund claims were not made or pay to Almacen the interest earned on the moneys on deposit.[5]

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[5] Petitioner made two calculations of the amounts of deposits not refunded to customers, one calculation in 1980 and another in 1985, when the case was tried. No satisfactory explanation is (footnote continued)

Petitioners did not show on financial statements made during 1976, 1977, and 1978 any liability for repayment of deposits to either Almacen or to customers.

4. The Jamaica Bank Account

In addition to the corporate account and the customer deposits account, petitioner, during 1977, 1978, and 1979, maintained in his own name an account, No. 302-78-2, with the Bank of Nova Scotia in Jamaica (sometimes hereafter referred to as the Jamaica account). Into this account, he regularly deposited sums withdrawn from the customer deposit account. The funds in the Jamaica account were available for use in enabling clients to meet the Jamaican $300 landing requirements. The total deposits in the Jamaica account were as follows:

Year	Amount
1976	$433,968.89
1977	$309,763.38
1978	$832,502.56.

The Jamaican dollar was devalued on the following dates so that it took more than one Jamaican dollar to buy an American dollar:

(footnote continued from previous page)
given for the differing amounts which are as follows:

	1980 Calculation	1985 Calculation
1976	$ 43,700	$147,050
1977	$ 67,000	$195,591
1978	$122,400	$354,300

Date	Jamaican Dollars to Buy American Dollar
4/25/77	1.248125
10/22/77	1.278125
1/14/78	1.348125
5/ 8/78	1.5475
6/ 8/78	1.571250
7/13/78	1.594375
8/11/78	1.61875

The amounts of the deposits in the Jamaica account exceeded the sums needed by Almacen to qualify Cuban clients to land in Jamaica. Even before the first devaluation of the Jamaican dollar in April 1977, petitioner regularly cleared the account of excess funds. After the first devaluation, he gave the Bank of Nova Scotia orders to transfer to him personally, on a monthly basis, all funds in the Jamaica account in excess of $4,000. The withdrawals of funds were not necessarily made at the end of the month.

Petitioner decided what was to be done with the excess deposits withdrawn from the Jamaica account and returned to him. Substantial amounts of the withdrawals were used to make personal investments in such items as bank certificates of deposit in his and Margarita's names and to purchase real estate or other property. The Internal Revenue Service (IRS) agents were unable to trace any funds withdrawn from the Jamaica account that were redeposited in the customer deposit account.

The IRS agents were able to trace funds withdrawn from the Jamaica account and used by petitioner to purchase bank certificates of deposit in the names of petitioner and Margarita as follows:

1. On March 11, 1976, petitioner withdrew $25,000 (American) from the Jamaica account and on March 29, 1976, purchased a $25,000 certificate of deposit (no. 3529) from the Sun Bank of Miami.

2. On June 29, 1976, petitioner withdrew $40,000 (American) from the Jamaica account and on July 2, 1976, purchased a $40,000 certificate of deposit from Republic National Bank of Miami (no. 7640).

3. On August 23, 1976, petitioner withdrew $38,355.16 (American) from the Jamaica account and on September 1, 1976, purchased a $38,356.16 certificate of deposit from AmeriFirst Bank in Miami (no. 71-00026469-9).

4. On September 22, 1976, petitioner withdrew $30,000 (American) from the Jamaica account and on September 27, 1976, purchased a $30,000 certificate of deposit from Sun Bank of Miami.

By letters dated February 1, 1979, March 1, 1979, and April 2, 1979, the Bank of Nova Scotia transmitted to petitioner drafts in the respective amounts of $108,796.13, $90,243.45, and $141,169.21, "per standing instructions on file." The examining revenue agent was unable to document the balance of the Jamaica account as of December 31, 1978. He estimated the balance by averaging the amounts of the drafts transmitted to petitioner by the bank with those letters.

5. Personal Bank Accounts

In addition to the bank accounts described above, petitioners maintained other personal bank accounts for themselves and their minor daughter, Twinky. They failed to report as income on their returns substantial amounts of interest earned on these accounts. During 1976, 1977, and 1978, Almacen's funds were used to cash employee payroll checks, and the employees' checks were then deposited in Margarita's personal bank accounts at Continental Bank and Republic National Bank and that of their daughter in Republic National Bank. Customers' checks for fees as well as customers' checks for deposits and currency were also placed in these personal accounts. The following table summarizes those deposits in Margarita's accounts and that of their daughter:

	1976	1977	1978
Continental - 060-602-7			
Customers' checks	$19,419.93	$ -0-	$ -0-
Employees' checks	7,073.09	1,683.96	-0-
Cash	24,991.50	-0-	-0-
Republic - 032-945-4			
Customers' checks	-0-	-0-	19,475.60
Employees' checks	-0-	10,194.03	5,502.43
Cash	-0-	200.00	-0-
Republic - 330-958-4			
Customers' checks	-0-	3,423.50	10,775.89
Employees' checks	-0-	5,074.77	11,077.42
Cash	-0-	6,407.00	51,800.00
Total	$51,484.52	$26,983.26	$98,631.34

6. Application of Net Worth Income Reconstruction Method

On their income tax returns for 1975 through 1979 petitioners reported the following amounts of adjusted gross income:

Year	Adjusted Gross Income
1975	$33,542.01
1976	$31,072.29
1977	$26,730.51
1978	$34,218.01
1979	$65,067.95

The accountant, Garcia, prepared petitioners' Federal income tax returns for 1976 through 1979. Petitioners provided him with summary information on their income, deductions, and credits rather than underlying documents. Respondent redetermined petitioners' income for 1976, 1977, and 1978 by use of the net worth increase and personal expenditures method of income reconstruction.

As of December 31, 1975, petitioners' net worth was $8,220.46, computed as follows:

Cash on hand	$ 500.00
Automobile--Buick Regal	5,000.00
Continental Bank 060-602-7	1,031.06
Bank of Nova Scotia	589.00
Sun Bank 41-792-7	1,100.40
Total net worth	$8,220.46

From their arrival in the United States through the end of the calendar year 1979, petitioners received no gifts, inheritances, pensions, loans, or other income derived from nontaxable sources, other than certain mortgages on real estate and two loans from Julio Rodriguez in 1978. These loans and mortgages were taken into consideration in computing petitioners' net worth for 1976, 1977, and 1978 as set forth below.

The following table summarizes petitioners' assets and liabilities and net worth increases for 1976, 1977, and 1978:

Item	1975	1976	1977	1978
Cash on hand	$ 500.00	$ 500.00	$ 500.00	$ 500.00
Cash in banks	2,720.46	152,567.20	244,223.60	301,494.19[1]
Real estate and other assets[2]	5,000.00	152,541.00	365,445.50	679,591.66
Total assets	$8,220.46	$305,608.20	$610,169.10	$981,585.85
Less: Liabilities	-0-	89,656.00	175,824.00	272,572.15
Net Worth	$8,220.46	$215,952.20 8,220.46	$434,345.10 215,952.20	$709,013.70 434,345.10
Increase in Net Worth		$207,731.74	$218,392.90	$274,668.60

[1] Petitioner contends that the amount included in this figure and related ones for the balance in the account at the Bank of Nova Scotia should be not more than $4,000 rather than $113,403 included under the above computations. The "Cash in banks" here shown includes the balances in six accounts in 1976 and eight accounts in 1977 and 1978.

[2] The assets included in these amounts include investment in numerous pieces of real estate, automobiles, stock, individual retirement accounts, furniture, and jewelry.

Petitioners' living expenses, income tax payments, and social security payments in 1976, 1977, and 1978 totaled $6,160.05, $34,191.49, and $40,832.47, respectively.

The parties are in agreement with respect to the foregoing increases in net worth in every respect except two items:[6] (1) The balance in the Jamaica account as of December 31, 1978, and (2) whether petitioners' liabilities should include the amounts of the customer deposits that had been received and not used or refunded by petitioner as of the ends of each of the years in controversy.

7. Negligence Issue for 1979

Because Almacen became a subchapter S corporation for its fiscal year ended April 30, 1979, its taxable income for that fiscal year was reflected (to the extent of 80 percent) in petitioners' joint income tax return for 1979. Several items of personal expense were paid from the corporate account and deducted in computing the income passed through Almacen to petitioners. Thus, on September 26, 1978, the Almacen account was used to pay premiums totaling $3,000 on life insurance policies on the lives of petitioners. On September 27, 1978, a check on Almacen's account for $14,619.93 was used to purchase an automobile in petitioner's name. Repair bills of $1,000 for petitioners' automobile were paid by Almacen on August 4, 1978, and deducted as a utility expense. On its fiscal year 1979 return, Almacen deducted reserves of $40,000 which the corporation set up as a bookkeeping credit for the repayment of fees in case the corporation was unable to provide the services.

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[6] In addition, petitioners' requested finding includes as an asset only $500 for jewelry for 1976 whereas it is stipulated, as pointed out by respondent, that the correct figure is $5,000. We assume that petitioners' error in the requested finding was inadvertent.

OPINION

1. The Deficiencies Issue

On examination of a taxpayer's return, the Commissioner may use the net worth increase method of reconstructing income to test the accuracy and completeness of the taxpayer's books and records. See, e.g., Schwarzkopf v. Commissioner, 246 F.2d 731, 743 (3d Cir. 1957), affg. a Memorandum Opinion of this Court; Vloutis v. United States, 219 F.2d 782, 786-787 (5th Cir. 1955); see generally Holland v. United States, 348 U.S. 121 (1954). If the test discloses unreported income, the Commissioner may use that method to determine deficiencies in the taxpayer's income. The taxpayer then has the burden of proving that the Commissioner's determinations are erroneous. Welch v. Helvering, 290 U.S. 111 (1933); Webb v. Commissioner, 394 F.2d 366, 372 (5th Cir. 1968), affg. a Memorandum Opinion of this Court.

In the instant case, respondent determined the substantial net worth increases and the deficiencies described above. Petitioners have stipulated to the accuracy of the figures underlying the net worth increases on which the determined deficiencies are based in every respect except two: (1) The balance in petitioner's account in the Bank of Nova Scotia as of December 31, 1978, and (2) respondent's failure to treat as a liability for each year an asserted obligation on the part of petitioner to refund sums deposited with Almacen by its customers but not refunded to the customer or used for Almacen's business purposes.

The Bank of Nova Scotia records on the December 31, 1978, balance in petitioner's account were not obtainable, according to petitioner, during the audit of petitioners' returns or at the trial. Although petitioner was subpoenaed to produce them, he testified that, because he had closed his account at the bank and the bank in Jamaica did not efficiently keep its records for prior years, he was unable to obtain the requested records. It is necessary, therefore, to estimate the balance in the account at the end of 1978.

The $113,403 figure used by respondent is the average of the amounts returned to petitioner by the bank with letters dated February 1, 1979, March 1, 1979, and April 2, 1979. These letters were sent pursuant to petitioner's instructions to clear the account monthly of funds in excess of $4,000. Petitioner contends that, as reflected by the dates of the transmittal letters, the account was cleared of excess funds at the end of each month and that the correct balance as of December 31, 1978, was thus $4,000.

Petitioner's $4,000 figure is not an acceptable estimate of the account's balance on December 31, 1978. Bank ledger sheets show that the Bank of Nova Scotia account was not cleared of excess funds at the ends of 6 other months in 1977 and 7 other months in 1978, the only months for which ledger sheets are available; in those months the account was reduced to $4,000 (or thereabouts) on other dates, ranging from the second day to the twenty-ninth day of the particular month. Further, the letters relied upon by petitioner reflect that the drafts used to transmit the excess funds were mailed from the bank in Jamaica to petitioner in Miami. Even if petitioner is correct that the Jamaica account was reduced to $4,000 on December 31, 1978, the inference is that the draft was in the mail to petitioner in Miami on that date and would be properly includable in petitioner's net worth as an asset at the end of 1978. Petitioner has not pointed to any 1978 (or other) deposit in a Miami bank that represents the proceeds of such a draft. We find that petitioner has not carried his burden of proof on this issue.

As to petitioner's liability to customers for the deposits, he contends that customers paid Almacen sums of money, parts of which were fees for services to be performed by Almacen and other parts were deposits designed to enable individuals entering the United States to meet the $300 Jamaican landing requirements. The fees portions of the payments, petitioner asserts, were deposited in the corporation's bank accounts and reported by Almacen as income. The deposits portions of the payments, on the other hand, were placed in petitioner's customer deposits account.

Petitioner argues that he became an escrow agent of the customers and Almacen with respect to the deposited sums and was liable to the customers and Almacen to carry out the purposes for which the deposits were made and to reimburse any losses that might arise from the relationship, citing Tucker v. Dr. P. Phillips Co., 139 F.2d 601 (5th Cir. 1943); Armbruster v. Alvin, 437 So.2d 725 (Fla. Dist. Ct. App. 1983). The amount of petitioner's obligation to Almacen and the customers with respect to the deposits, he argues, should, therefore, be applied to reduce the net worth increases determined by respondent. We do not agree.

The bank account in which petitioners placed these deposited amounts was neither designated nor treated as an escrow or fiduciary account. Instead, petitioner in his own testimony described the account as representing "the money of the customers that I deposit in my account." The accountant who prepared the tax returns of Almacen and petitioners for years after 1975 testified that the account was "in their [petitioners'] name and they treated it as theirs." The parties stipulated on the record that "the monies in the accounts actually belong to Mr. and Mrs. Rodriguez." And petitioner directly or indirectly used the money deposited in the account to make many of the personal investments described in our findings which, to a large extent, explain the increases in his net worth at the rate of more than $200,000 for each of the years in controversy.

As we view the evidence, petitioner used his control over Almacen and his dealings with its customers to divert to himself money which he was free to, and did, use and dispose of at will. From such use of the money, petitioner obtained readily realizable economic value in the form of investments in real estate and other property and certificates of bank deposits in his and his spouse's own names. These benefits from the diverted funds are sufficient to bring the funds within the broad sweep of gross income as defined in section 61. The fact that he refunded some of the diverted funds in no way relieves him of tax on the funds he kept. United States v. Rosenthal, 470 F.2d 837, 842 (2d Cir. 1972); Davis v. United States, 226 F.2d 331, 334 (6th Cir. 1955); Leaf v. Commissioner, 33 T.C. 1093, 1096 (1960), affd. 295 F.2d 503 (6th Cir. 1961); see also Stovall v. Commissioner, 762 F.2d 891 (11th Cir. 1985), affg. a Memorandum Opinion of this Court.

The possibility that petitioner may eventually be called upon to refund some of the deposits does not relieve him of tax on them in the year he diverted them to his own use. In North American Oil v. Burnet, 286 U.S. 417 (1932), an oil company received income from oil properties in receivership in 1917, but its right to such income was not resolved until 1922, the year in which litigation affecting the fund was closed. The Court explained (286 U.S. at 424):

> If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent. * * * If in 1922 the Government had prevailed, and the company had been obliged to refund the profits

> received in 1917, it would have been entitled to a deduction from the profits of 1922, not from those of any earlier year. [Citations omitted.][7]

Similarly, petitioner personally received the customer deposits during 1976, 1977, and 1978, treated them as his own, and used them for his own purposes, without restriction. The deposits were taxable to him when he received them even though he was later called upon to refund a portion of them and may be asked for further refunds. The net worth increase computation, in effect, gives petitioner a deduction for any refunds made in the years in controversy in that the refunded amounts did not increase petitioner's net worth as of the ends of those years.

The same conclusion would be called for if, as he contends, petitioner received the funds from Almacen and its customers as escrow agent. His conversion of such funds to his own use in those circumstances would be akin to embezzlement of trust funds, and it is now well established that embezzled funds are taxable income. As explained in James v. United States, 366 U.S. 213, 219 (1961):

> When a taxpayer acquires earnings, lawfully or unlawfully, without the consensual recognition, express or implied, of an obligation to repay and without restriction as to their disposition, "he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent." * * * In such case, the taxpayer has "actual command over the property taxed--the actual benefit for which the tax is paid." * * * This standard brings wrongful

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[7] The rule for handling deductions for amounts received under a claim of right and subsequently restored is now prescribed by sec. 1341, et seq.

> appropriations within the broad sweep of "gross income"; it excludes loans. * * * [Citations omitted.]

See also, e.g., Moore v. United States, 412 F.2d 974, 979-980 (5th Cir. 1969); McSpadden v. Commissioner, 50 T.C. 478, 488-489 (1968).

There is no evidence supporting an argument that there was a "consensual recognition" by petitioner and the customers of an obligation to refund deposits not used by Almacen clients for entries through Jamaica. The record does not contain any agreement by petitioner with Almacen or its customers obligating petitioner to make refunds or informing customers that they could claim refunds. In fact, the receipt form issued to customers contains nothing even suggesting a possible refund. From the testimony it is clear, as we have found to be the fact, that refunds were made only to customers who demanded them; if a customer did not demand a refund, he did not get one. Petitioner's financial statements prepared during the relevant period do not list as a liability any obligations to make refunds of deposits.

We are convinced that many customers did not have even the slightest inkling that they could have had any of their deposits refunded to them in any circumstances. The mere possibility that demands may eventually be made for refunds, or that petitioner has an obligation to make requested refunds, does not relieve him of tax on the diverted funds. United States v. Rosenthal, 470 F.2d at 842; Quinn v. Commissioner, 524 F.2d 617, 625 (7th Cir.

1975), affg. 62 T.C. 223 (1974); Leaf v. Commissioner, 33 T.C. at 1096.

2. The Fraud Issue

Section 6653(b) provides for the imposition of a 50-percent addition to tax if any part of any underpayment of tax is "due to fraud." Under this statute, fraud is established if it is shown by clear and convincing evidence that the taxpayer intended to evade taxes believed to be owing by conduct designed to conceal, mislead, or otherwise prevent the collection of such taxes. Stoltzfus v. United States, 398 F.2d 1002, 1004-1005 (3d Cir. 1968); Webb v. Commissioner, 394 F.2d 366, 377-378 (5th Cir. 1968), affg. a Memorandum Opinion of this Court; Rowlee v. Commissioner, 80 T.C. 1111, 1123 (1983). The burden of showing fraud by clear and convincing evidence rests with respondent. Sec. 7454. Respondent has made the requisite showing.

The record shows, as we have discussed, that petitioner in 1976, 1977, and 1978 increased his net worth to the extent of more than $200,000 per year mainly by diverting Almacen's corporate funds to his own use. In these same years, he reported adjusted gross income of less than $35,000 per year, and the parties have stipulated that petitioner's nondeductible expenditures for living expenses, social security payments, and income tax payments exceeded those amounts of reported adjusted gross income in 2 of the 3 years.

Petitioner is a highly intelligent individual and an astute businessman. We are convinced that he knew that he was not reporting all of his taxable income in those years and that he intended to evade taxes on the unreported amounts. This substantial understatement of income in successive years may be taken as evidence of fraud. Schwarzkopf v. Commissioner, 246 F.2d at 734.

As explained in our findings, petitioner's accountant recommended that Almacen maintain two bank accounts, one for fees and one for deposits in order to segregate the taxable fees from the nontaxable deposits. The reason for the segregation, we are convinced, was made clear. Yet petitioner's spouse regularly deposited in her personal checking accounts and that of a daughter customer checks that had been received by Almacen to cover customers' fees as well as deposits. In addition, Almacen cashed its payroll checks with corporate funds and petitioner's spouse then deposited the payroll checks in her personal checking accounts, thus siphoning money out of Almacen. We find that these substantial diversions of corporate funds to petitioners' personal accounts were carried out in this manner with the purpose and design of avoiding income tax on those amounts.

In a variety of other ways petitioners received earnings which were not reported as income. Petitioners retained the excess of customer deposits over the amounts refunded in cases in which refunds were made. Thousands of dollars of the deposits were not refunded. The deposited sums drew interest for petitioners at the banks. The full amount of the interest earned on certificates of deposits and savings accounts was not reported as income. In the absence of any other adequate explanation, we think these maneuvers were designed to evade taxes known to be owing on those accretions to petitioner's wealth.

The manner in which petitioner handled the Bank of Nova Scotia account reveals a further effort to evade taxes on their income. They used the Jamaica account to "launder" substantial amounts of customer deposits so that they could not be easily traced when they were returned to the United States. Petitioner frequently transmitted to the Bank of Nova Scotia sums far in excess of the amounts needed to enable clients arriving from Cuba to meet the $300 Jamaican entry requirements. Petitioner was unable to give a satisfactory explanation of why he made those excess deposits. The excess funds were then cleared from the account by drafts payable to petitioner. The IRS was unable to trace any such drafts back into the customer deposits account and petitioner pointed to none. Our findings lists four withdrawals of funds from the Bank of Nova Scotia account which the IRS traced directly to the purchases in 1976 of certificates of deposit totaling over $130,000. In addition to these four traced deposits, other amounts were used to purchase in petitioners' names certificates of deposit and real estate. We think the practice of making and then withdrawing excess deposits from the Jamaica account was designed to conceal the use of customer deposits for making personal investments.

Petitioners did not maintain books and records which disclosed the above-described diversions of corporate income to their own use. They thus provided their income tax return preparer as well as the IRS agents with incomplete and misleading records. The IRS agents were compelled to develop many of the facts set forth in our findings through painstaking investigation.

The evidence is clear, as we view it, that petitioners attempted to defeat the payment of income tax on substantial amounts of their income. We find that respondent has carried his burden of proof that a substantial part of petitioners' underpayment of tax was due to fraud within the meaning of section 6653(b).

3. The Negligence Issue

Section 6653(a) provides for the imposition of a 5-percent addition to tax if any part of an underpayment is due to negligence or intentional disregard of the rules. The burden of proof as to this addition to tax rests with petitioner. Bixby v. Commissioner, 58 T.C. 757, 791-792 (1972); Rosano v. Commissioner, 46 T.C. 681, 688 (1966).

To support his determination, respondent cites the following items, all of which relate to the income of Almacen, the subchapter S corporation, the income of which was passed to petitioners: Almacen deducted $14,619.93 paid for an automobile registered in petitioner's name; Almacen deducted $3,000 for the premium on personally owned life insurance on the lives of petitioners; Almacen deducted $1,000 for the repair of petitioner's automobile; and Almacen deducted $40,000 as reserve for a contingent liability to repay fees in case the corporation was unable to perform the services which it had contracted to perform. Petitioners have not contested the disallowance of deductions for those items but they have offered no evidence to explain how they came to make the mistakes.

Petitioner was president and manager and Margarita was treasurer and bookkeeper of Almacen. She supplied information to the accountant who prepared their returns. They are thus responsible for the errors leading to these mistakes. The IRS investigation of petitioners' 1976, 1977, and 1978 returns was under way when petitioners filed their 1979 return. Quite obviously, they had taken some steps to correct to some extent their income tax recordkeeping and reporting shortcomings, but we have no evidence as to how these 1979 errors occurred or as to the care they took to avoid negligent underreporting of their income. Because the burden of proof on this issue rests on petitioners, we must sustain the section 6653(a) addition to tax.

To reflect the foregoing,

Decision will be entered
under Rule 155.

742-B JU 11.7/2: 1986-9

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T. C. Memo. 1986-9

COMPLETED
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UNITED STATES TAX COURT

JOHN JOSEPH MARTIN, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 23257-83. Filed January 9, 1986.

John Joseph Martin, pro se.

Randall E. Heath, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

PAJAK, Special Trial Judge: This case was assigned pursuant to the provisions of section 7456(d) of the Internal Revenue Code and Rule 180, et seq.[1] for the purpose of considering and ruling on respondent's Motion for Judgment on the Pleadings filed pursuant to Rules 38 and 120 on May 14, 1984.

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[1] All section references are to the Internal Revenue Code of 1954 in effect during the taxable year in issue, unless otherwise indicated. All rule references are to the Tax Court Rules of Practice and Procedure.

ORIGINAL BEST COPY AVAILABLE

Respondent determined a deficiency in petitioner's 1979 Federal income tax in the amount of $2,508, and additions to tax under sections 6651(a), 6653(a), and 6654 in the amounts of $583, $103, and $95, respectively. Respondent also requested that the Court award damages to the United States pursuant to section 6673.

At the time of filing his petition, petitioner resided in Portland, Oregon. Petitioner's petition, contrary to Rule 34(b), contains no clear and concise assignments of error alleged to have been committed by respondent nor does it set forth any allegations of justiciable facts with respect to assignments of errors.

On December 2, 1983,[2] respondent filed his Answer in which he alleged the above mentioned deficiency and additions to tax. He further alleged as follows:

> 5. FURTHER ANSWERING the petition, and in support of the respondent's request that the Court award damages to the United States pursuant to section 6673 of the Internal Revenue Code of 1954, the respondent alleges the following:
>
> a) During 1979 the petitioner received W-2 wage income from the following employers in the following amounts:
>
> | Employer | Amount Earned |
> |---|---|
> | Marine Ways | $ 487.56 |

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[2] Respondent moved for leave to file an answer out of time pursuant to Rule 75(c) on November 23, 1983. We granted respondent's motion on December 2, 1983.

Dix Corporation	2,504.36
Northwest Marine Iron Work	9,454.84
Harder Mechanical Contractors	515.06
Interlake Inc.	2,676.69
Total Wages	$15,638.51

b) The employers issued forms W-2 to the petitioner indicating the amount of income received by him.

c) Petitioner failed to file a valid income tax return for the taxable year 1979.

d) Respondent issued to petitioner a statutory notice of deficiency for the year 1979 asserting a deficiency in petitioner's income tax based solely on the wages received by petitioner and reported on the W-2 forms issued to him.

e) Petitioner filed on August 5, 1983[3] a petition to the United States Tax Court in which he alleged no justiciable errors in the respondent's determination nor did he allege any facts upon which to base any assignments of error.

f) The petitioner has made no allegations or claims upon which relief can be granted.

g) The petitioner has instituted and maintained the instant proceedings primarily for delay and the petitioner's position in these proceedings is frivolous and groundless.

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[3] This is an obvious typographical error in that petitioner's petition was filed on August 9, 1983.

On October 21, 1983, respondent informed petitioner by letter that unless petitioner filed a reply to respondent's answer within the time period set forth in Rule 37, respondent would move to have the affirmative allegations set forth in his answer deemed admitted.

Despite these admonitions, petitioner failed to file a reply. On February 6, 1984, respondent moved for entry of an order that the undenied allegations in the answer be deemed admitted pursuant to Rule 37(c). Notice of that motion was served on petitioner on February 9, 1984 and he was given until March 1, 1984 to file a reply as required by Rule 37(a) and (b).

Petitioner failed to file a reply. On March 9, 1984, the Court entered an order which granted respondent's motion and deemed admitted the affirmative allegations of fact set forth in paragraphs 5(a) through 5(g) of respondent's answer. Copies of that order were served on March 12, 1984.

On May 14, 1984, pursuant to Rules 38 and 120, respondent filed his Motion For Judgment On The Pleadings. An attempt to serve that motion on petitioner together with a notice of hearing on the motion on July 23, 1984, in Portland, Oregon was futile as these documents were returned to the Court marked "NOT DELIVERABLE AS ADDRESSED UNABLE TO FORWARD." Petitioner did not appear at the hearing or otherwise respond to respondent's motion nor did he inform the Court of a change in his address.

On this record, it is clear that respondent is entitled to judgment on the pleadings.

After filing his petition and an affidavit with the Court, petitioner refused to go forward with his case. This, together with a statement contained in the affidavit to the effect that the Internal Revenue Service is a "DICTATORSHIP" shows that petitioner has raised only tax protester type arguments. Rowlee v. Commissioner, 80 T.C. 1111 (1983). On this record, we find that the proceedings in this case have been instituted or maintained by petitioner primarily for delay and that his position in this case is groundless and frivolous. Therefore we award damages of $2,000 to the United States pursuant section 6673.

An appropriate order
and decision will be entered.

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JU 11.7/2:1986-10

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T. C. Memo. 1986-10

UNITED STATES TAX COURT

JAMES J. FREELAND AND MAXINE FREELAND, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 18708-82. Filed January 9, 1986.

W. Gerald Thornton and David D. Dahl, for the petitioners.

Edwina L. Wilson, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

SHIELDS, Judge: Respondent determined that deficiencies in income tax and additions to tax are due from petitioners for the years 1977 and 1978 as set forth below:

		Additions to Tax	
Year	Deficiency	Sec. 6651(a)(1)[1]	Sec. 6653(a)(1)
1977	$17,378.14	$6,287.47	$1,307.49
1978	3,293.62	-0-	164.68

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[1] All section references are to the Internal Revenue Code of 1954, as in effect during the years in issue, unless otherwise indicated. All rule references are to the Tax Court Rules of Practice and Procedure, unless otherwise provided.

ORIGINAL

Due to concessions, the issues remaining for decision are: (1) whether certain litigation expenses incurred by petitioners in the defense of a foreclosure action constitute deductible expenses or nondeductible capital expenditures; (2) whether litigation expenses incurred by petitioners in a separate corollary action in which they were named defendants and counter claimed for damages for slander of title constitute deductible expenses or nondeductible capital expenditures; (3) whether petitioners' failure to timely file their 1977 return was due to reasonable cause within the meaning of section 6651(a)(1); and (4) whether the underpayment, if any, in petitioners' income tax for 1977 or 1978 is due to negligence or intentional disregard of rules and regulations under section 6653(a)(1).[2]

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulations and exhibits attached thereto are incorporated herein.

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[2] Petitioners have assigned error to respondent's allowance of additional depreciation deductions in 1977 and 1978 and an additional sales tax deduction in 1977. These adjustments arise from respondent's determination that the litigation expenses in issue must be capitalized instead of expensed. Consequently, the depreciation and sales tax adjustment issues will be resolved by the outcome of the first two issues.

At the time their petition was filed, petitioners resided in Hillsborough, North Carolina. They filed joint income tax returns for the years 1977 and 1978 with the Internal Revenue Service Center at Memphis, Tennessee.

In 1941, petitioner, James J. Freeland, whose education ended in the sixth grade, started constructing houses and commercial buildings such as restaurants and motels. Some of his construction was done under contracts with other parties while some of it was done on land owned by petitioners. He continued to do such construction up through 1977 and 1978, the years under consideration.

In 1964 he and Mrs. Freeland bought a tract of land containing 83 acres at an exit from Interstate 85 near Hillsborough. At that time, the tract was improved with three barns and an old house. Starting in 1965 and continuing through 1971, Mr. Freeland remodeled the barns and the house and personally constructed other buildings and improvements until the tract contained a motel, a campground, an amusement park, a restaurant, several stores and shops, a skating rink and other businesses, all of which were known as the Daniel Boone Complex ("DBC"). Petitioners operated the motel and skating rink. The other businesses were operated by other parties under leases from petitioners. All of the improvements were of a primitive nature, since they were constructed from old wooden materials salvaged by Mr. Freeland from the demolition of other buildings. The construction stopped about the end of 1971 because of the bad health of both petitioners and they decided at that time to sell the complex.

On May 2, 1972, petitioners entered into a contract to sell the DBC to Matthew N. and Genevieve D. Mezzanotte ("Mezzanottes") or their assignees. Shortly after entering into the purchase and sale agreement, the Mezzanottes assigned their rights therein to Daniel Boone Complex, Inc. ("DBC, Inc."), a new North Carolina corporation which they had organized. The Mezzanottes then sold all of the outstanding stock in DBC, Inc. to Camilco, Inc. ("Camilco"). All of Camilco's stock was owned by Linda Broyhill McGillan, who permitted DBC, Inc. to remain as a wholly owned subsidiary of Camilco.

Under the original contract, the purchase and sale of DBC was to have occurred in 1972, but for several different reasons the sale was delayed until 1974. One of the reasons for the delay was a lawsuit instituted by the Mezzanottes and DBC, Inc. against petitioners in the Superior Court of North Carolina for specific performance on the contract of sale plus damages for the breach thereof. The Superior Court found for the plaintiffs and ordered petitioners to convey DBC to the purchasers in accordance with the sale contract and to pay them damages in the amount of $100,000. The decision of the Superior Court was affirmed by the North Carolina Court of Appeals and in January of 1974 the North Carolina Supreme Court declined to grant certiorari. *Mezzanotte v. Freeland*, 20 N.C.App. 11, 200 S.E.2d 410 (1973), cert. denied 284 N.C. 616, 201 S.E.2d 689 (1974).

By deed dated March 1, 1974, and recorded on March 15, 1974, petitioners conveyed DBC to DBC, Inc. At the closing of the sale, petitioners received $200,000 in cash and a promissory note for the balance of the purchase price of $1,085,000. The note was payable in 20 annual installments, commencing on March 1, 1975 and bore interest at the rate of 7 percent per annum, payable annually. The promissory note was secured by a deed of trust on the DBC land, buildings, and other improvements. It was also secured by a chattel mortgage on the furniture, fixtures and other personal property of DBC.

Since the buildings and other improvements of DBC were particularly subject to destruction by fire, petitioners caused the following provision to be inserted in the deed of trust:

> That the said party of the first part [DBC, Inc.] will insure and keep insured the buildings and contents on the premises herein conveyed against loss by fire and wind-storm during the existence of this indebtedness in an amount satisfactory to the holder of the Note [petitioners] not to exceed the unpaid balance thereon and will assign said insurance to the holder of the Note as his interest may appear for the security of any and all amounts which may be due him; and, should the party of the first part fail to cause such insurance to be issued and assigned as aforesaid or fail to pay any premium therefore, then the said holder of the Note is authorized to effect such insurance or to make such premium payments as may be due, if he so elects, and such sums so paid shall be a lien against the said premises and immediately due and payable to the holder of the Note and shall be secured hereby to the same extent as the principal amount herein described.

The purpose of the above insurance was to protect the security for the note taken by petitioners as part of the purchase price. However, DBC, Inc. failed to furnish petitioners at the closing with evidence of the insurance as required under the deed of trust. Consequently, after the closing of the purchase and sale, petitioners obtained the necessary fire and casualty insurance on the DBC property at a cost of $27,005 and demanded reimbursement for the cost of the insurance from DBC, Inc. Subsequent to the closing, petitioners also became aware of the fact that DBC, Inc. had purchased certain building materials, supplies, and construction services on credit, had failed or refused to pay for the same, and had permitted liens to be filed against DBC, Inc. and its property, including DBC.

During May, June, and part of July of 1974 petitioners through their attorney, Dalton Hartwell Loftin, who was also the trustee under the deed of trust, made several attempts to obtain reimbursement for the insurance from DBC, Inc. The attempts included letters to the effect that unless the terms of the deed of trust with respect to insurance were complied with foreclosure would be undertaken even though at that time there was no interest or principal due on the note. By letter dated July 2, 1974 DBC, Inc. was informed by petitioner's attorney that DBC, Inc. was in default under the deed of trust and the chattel mortgage because of its failure to reimburse petitioners for the cost of the insurance. On July 22, 1974 petitioners exercised their option to accelerate the total debt secured by the deed of trust and the chattel mortgage and, at their request, the trustee gave notice of sale of the realty pursuant to the deed of trust and of the personalty pursuant to the chattel mortgage. This action was recommended to petitioners by their counsel because of the failure of DBC, Inc. to make any response to his demands for reimbursement of the insurance premium and because in his opinion foreclosure was necessary in order to clear the property of the liens filed by creditors of DBC, Inc.

The foreclosure sale was originally scheduled for August 23, 1974, but on August 21, 1974, DBC, Inc. and others filed a complaint against petitioners and the trustee under the deed of trust in the Superior Court in which they sought both temporary and permanent injunctive relief from the pending foreclosure sale. Plaintiffs in the lawsuit were granted a temporary restraining order, but on August 28, 1974 the restraining order was dissolved and the foreclosure occurred on August 30, 1974. At the sale, petitioners made tne highest bids for the real property under the deed of trust and the personal property under the chattel mortgage.

After the foreclosure sale, DBC, Inc. and the other plaintiffs amended their complaint so as to seek to have the foreclosure set aside with an award for damages for the interim loss of profits or, in the alternative, an award for damages for the loss of the property. At the trial, the plaintiffs elected to seek damages only and abandoned their attempt to recover DBC.

On July 11, 1975, the Superior Court granted a motion by plaintiffs for partial summary judgment to the effect that the deed of trust and chattel mortgage had been wrongfully foreclosed. On appeal by petitioners, the North Carolina Court of Appeals reversed the partial summary judgment and remanded the matter to the Superior Court for further proceedings. On August 19, 1977, a decision was entered by the Superior Court in which it was held that the foreclosure was valid and that the plaintiffs were not entitled to any damages from petitioners. The plaintiffs appealed the decision to the Court of Appeals but while the appeal was pending petitioners, on December 24, 1977, paid $11,000 to the plaintiffs in full settlement of the matter.

At the same time that DBC, Inc. joined in the wrongful foreclosure proceeding against petitioners, DBC, Inc. also joined in a separate corollary action in the Superior Court of Orange County, North Carolina. In this action, petitioners counterclaimed for damages for slander of their title to the DBC property. This action was dismissed on August 12, 1977.[3]

In connection with the two suits, petitioners incurred and paid litigation expenses in the years 1977 and 1978 in the respective total amounts of $34,650.00 and $11,316.44. The 1977 expenditures consisted of $20,200.00 in attorney fees, the $11,000.00 in settlement of the foreclosure suit, and $3,450.00 in witness fees in the same suit. The 1978 expenditure of $11,316.44 consisted entirely of attorney fees. An exact allocation of the attorney fees as between the foreclosure action and the corollary matter cannot be made from the record. The parties, however, stipulated that only a "minor portion" of the total in attorney fees was incurred in connection with the corollary action.

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[3] While the record is unclear, the action was apparently dismissed by agreement of the parties.

For 35 years prior to 1977, petitioners' income tax returns were prepared by R. C. Neighbors, an accountant, from information furnished by petitioners. Their information for the 1977 return was also turned over to Mr. Neighbors and at his request respondent granted an extension of time until June 15, 1978, in which to file the 1977 income tax return. No further extensions were requested. The 1977 return of petitioners was filed on January 25, 1979.

OPINION

Litigation Expenses

Petitioners contend that all of the legal fees, witness expenses and settlement costs incurred in the wrongful foreclosure action as well as the corollary matter are ordinary and necessary expenses incurred by them in an effort to collect, or protect the ultimate collection, of the interest bearing (income producing) note which they received in the sale of DBC and are deductible under section 212(1) and (2).[4]

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[4] Section 212 provides:

> In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year--
>
> (1) for the production or collection of income;
>
> (2) for the management, conservation, or maintenance of property held for the production of income; or
>
> (3) in connection with the determination, collection, or refund of any tax.

Respondent's first contention is that the legal fees, witness expenses and settlement costs were incurred by petitioners in the defense or perfection of title to DBC and are nondeductible capital expenditures under section 263(a).[5] Spangler v. Commissioner, 323 F.2d 913, 919 (9th Cir. 1963), affg. T.C. Memo. 1961-341; sections 1.263(a)-2(c) and 1.212-1(k), Income Tax Regs. Secondly, respondent argues that the litigation expenses should be capitalized because the origin of the litigation was in the original sale of a capital asset. Reed v. Commissioner, 55 T.C. 32 (1970); Anchor Coupling Company, Inc. v. United States, 427 F.2d 429, 433 (7th Cir. 1970), cert. denied 401 U.S. 908 (1971).

In determining whether legal fees and other litigation expenses are deductible under section 212 or must be capitalized under section 263(a) the origin of the litigation is the controlling test; and under this test, if the claim has its origin in the acquisition of a capital asset, no ordinary expense deduction is allowable. Woodward v. United States, 397 U.S. 572 (1970); United States v. Hilton Hotels, 397 U.S. 580 (1970).

In determining whether the underlying transaction is capital in nature, the search for the origin of the claim is not limited to a simple determination of the first event in a chain which led to the litigation but, instead is "an examination of all the facts * * * to [ascertain] the 'kind of transaction' out of which the litigation arose." Boagni v. Commissioner, 59 T.C. 708, 713 (1973). In other words, the test includes a consideration of "the nature and objectives of the litigation, the defenses asserted, the purpose for which the claimed deductions were expended, the background of the litigation, and all facts pertaining to the controversy." Boagni v. Commissioner, 59 T.C. at 713.

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[5] Section 263(a) provides in relevant part:

> (a) GENERAL RULE.--No deduction shall be allowed for--
>
> (1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. * * *

Examination of all the facts pertaining to the controversy involved in this case clearly indicates that the wrongful foreclosure action was filed against petitioners by DBC, Inc. after and in direct response to petitioners' declaration of a default on the note, their exercise of the option to accelerate the installment payments, and their initiation of foreclosure proceedings. Consequently, all fees and other litigation expenses incurred by petitioners in connection with the issuance of the temporary restraining order, its dissolution by the trial court, the subsequent trial, the appeal and its subsequent settlement were all directly attributable to the foreclosure proceedings. It is apparent, therefore, that in this case the "kind of transaction out of which the litigation arose" was a foreclosure action of which the "nature", "objective" and "purpose" was to remove the title to DBC from DBC, Inc. Since petitioners were the successful bidders at the foreclosure sale, the end result of the transaction was a reacquisition of the title to DBC by petitioners. Therefore, all of their litigation expenses are attributable to the reacquisition of title and are not deductible under section 263(a).

Petitioners contend, however, that the foreclosure was instituted solely to collect their note, an income producing asset, and that fees and other expenses incurred in connection with such collection activity even on a note or other evidence of debt received in the sale of a capital asset is deductible under *Doering v. Commissioner*, 39 T.C. 647 (1963), affd. 335 F.2d 738 (2d Cir. 1964), and *Naylor v. Commissioner*, 203 F.2d 346 (5th Cir. 1953), revg. 17 T.C. 959 (1951). Their reliance in this case on those opinions is misplaced, however, because in both *Doering v. Commissioner*, *supra*, and *Naylor v. Commissioner*, *supra*, the litigation in which the disputed expenses were incurred did not result in the acquisition of title by the taxpayers. Here, the end result of the transaction was the acquisition of title. Consequently, all expenses incurred in connection with the transaction are reflected in the cost of the asset or assets acquired. We see no reason why this result would be affected by the fact that at the beginning of the foreclosure petitioners may not have intended to acquire title but only to collect their note. Their motive or purpose at that time is not controlling. *Yates Industries, Inc. v. Commissioner*, 58 T.C. 961 (1972).

Neither party has devoted much discussion to the portion of the attorney fees paid by petitioners with respect to the second suit in the Superior Court. They did stipulate that it was a "corollary action" to the wrongful foreclosure suit and that only a "minor part" of the total in attorney fees was attributable to it. In any event, we note that petitioners' counterclaim was for slander of title which clearly leads to an inference that their defense to the suit was based upon a claim of title. Consequently, the deduction of this portion of the attorney fees is not allowable because expenditures to defend title or to assert slander of title are also capital in nature. Spangler v. Commissioner, 323 F.2d 913 (9th Cir. 1963), affg. T.C. Memo. 1961-341.

Failure to File Timely Return

Respondent determined that petitioners are liable for the addition to tax provided by section 6651(a)(1) for failing to timely file their 1977 income tax return. Petitioners contend that they are not liable for the addition to tax because they relied in good faith upon their accountant of 35 years to make a timely filing on their behalf with the information which they had provided. Unfortunately for them, the Supreme Court has recently held that the failure to make "a timely filing of a tax return is not excused by the taxpayer's reliance on an agent, and such reliance is not 'reasonable cause' for a late filing under section 6651(a)(1)." United States v. Boyle, 469 U.S. ___ (1985). Since petitioners' reliance upon the accountant is their sole defense to the addition to tax under section 6651(a)(1), they have failed to overcome the presumption that respondent's determination with respect to the addition is correct.

Therefore, respondent's determination with respect to the addition under section 6651(a)(1) is sustained. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a).

Negligence

In the statutory notice, respondent determined that the deficiencies in tax due from petitioners for 1977 and 1978 were due to their negligence or intentional disregard of rules and regulations. Petitioners have the burden of proving this determination to be incorrect. Pritchett v. Commissioner, 63 T.C. 149 (1974); Bradley v. Commissioner, 57 T.C. 1 (1971).

Respondent contends that petitioners' deduction of the litigation expenses constitutes negligence under section 6653(a) because such expenses clearly constituted "nondeductible capital expenditures." Under the circumstances outlined in our findings, we are unable to agree with respondent inasmuch as this particular question has been the subject of a great deal of litigation over a number of years and both lawyers and accountants who are thoroughly familiar with the subject and the numerous cases on the point frequently disagree as to whether an item constitutes a deductible expense or a capital expenditure. Therefore, we are unable to find that the deduction in this case by petitioners constituted negligence or the intentional disregard of rules and regulations.

Decision will be entered
under Rule 155.

742-B

Ju 11.7/2:1986-11

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T. C. Memo. 1986-11

UNITED STATES TAX COURT

WILLIAM M. ROBERTS AND GERRI L. ROBERTS, Petitioners
v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 20363-82. Filed January 9, 1986.

William M. Roberts, pro se.

Walter T. Thompson, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

SHIELDS, *Judge*: Respondent determined a deficiency in petitioners' Federal income tax of $3,588.00 for the taxable year 1979. The issues are: (1) whether petitioner, William M. Roberts, realized a loss upon the transfer of his interest in certain properties pursuant to a divorce decree; (2) whether petitioners are entitled to a deduction and, if so, the amount thereof for depreciation on rental properties; and (3) whether petitioners are entitled to miscellaneous deductions and, if so, the amount thereof for certain expenses paid in connection with rental properties.

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FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulations of fact and attached exhibits are incorporated herein by reference.

Petitioners, William M. Roberts and Gerri L. Roberts, husband and wife, resided in Wilcox, Arizona, at the time of the filing of their petition. They filed a joint income tax return for the taxable year 1979 with the Internal Revenue Service at Ogden, Utah.

Prior to his marriage to Gerri L. Roberts, William M. Roberts ("William") was married to Lana L. Roberts ("Lana"). He and Lana were divorced in September 1979 by a decree entered by the Superior Court of Maricopa County, Arizona. The divorce decree incorporated a property settlement agreement ("Agreement") which provided for an "equitable division and partition of [their] community[1] and joint property" described generally in the agreement as the Haskell Apartments, the Biddle Street Apartments, the Desert Breeze Motel, and the Diehl Properties (containing a laundromat and two apartments). Pursuant to the Agreement, the Haskell Apartments and the Biddle Street Apartments were deeded to William as his separate property and the Desert Breeze Motel and the Diehl Properties were deeded to Lana as her separate property. Each of them covenanted to be separately responsible for all liens, encumbrances, assessments and taxes on his or her separate property. William and Lana also agreed that they each owned one-half of the laundromat business located in the Diehl Properties. William, however, transferred all his right, title and interest in the business to Lana in lieu of any claim she might have against him for child support for their two minor daughters and Lana assumed and agreed to pay a $10,000 debt which they jointly owed to his parents. She also agreed to secure this debt with a second mortgage on the Diehl Properties.

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[1] Arizona Revised Statutes Annotated, section 25-211 (1976), provides:

> All property acquired by either husband or wife during the marriage, except that which is acquired by gift, devise or descent, is the community property of the husband and wife.

The Desert Breeze Motel had been purchased by William and Lana in 1975 for $115,000, of which $25,000 was paid in cash with the balance being represented by two mortgages totaling $90,000. William testified that the Haskell Apartments and the Biddle Street Apartments were purchased by them in 1975 for approximately $22,000 and $12,000, respectively, and that at the date of purchase the Haskell Apartments was subject to a mortgage of approximately $25,000 and the Biddle Street Apartments was subject to a mortgage of about $5,000 or $6,000. The record contains no evidence as to the cost or the encumbrances, if any, on the Diehl Properties, other than the $10,000 owed to William's parents. Furthermore, no evidence was presented as to the amounts outstanding on any of the mortgages at the time of the divorce or as to the value of the laundromat business or the cost of supporting the two minor daughters until they reached their majority.

On their 1979 income tax return, petitioners claimed a loss in the amount of $14,047 from William's exchange of his interest in the Desert Breeze Motel and the Diehl Properties for Lana's interest in the Haskell Apartments and the Biddle Street Apartments. Petitioners also claimed a depreciation deduction from rental income in the amount of $2,935 computed as follows:

Description	Date Acquired	Cost or Other Basis	Salvage or Land Value	Net Amount Eligible For Depreciation	Business Use	Depreciation Allowed in Prior Years	Method Used	Useful Life	Depreciation for 1979
Biddle Street Apartments	1975	$13,070	$4,520	$8,550	100%	$2,185	Straight Line	15	$570
Haskell Apartments	1975	9,870	970	8,900	100%	2,026	Straight Line	15	593
New Apartment at Haskell Apartments	10-1-78	26,000	2,600	23,400	100%	234	——	25	936
Refrigerators and Stoves at Haskell Apartments	2-10-78	2,615	262	1,830	100%	218	Straight Line	7	261
Furniture at Haskell Apartments	1978	3,251	375	2,876	100%	1,300	Straight Line	5	575

Additional rental deductions totaling $4,017 were also claimed by petitioners with respect to an automobile, gardening, insurance, interest, repairs, supplies, telephone, taxes and licenses.

OPINION

Petitioners contend that they realized a loss on the exchange between William and Lana under the Agreement incorporated into the divorce decree and that the loss should be recognized for tax purposes under the law in effect at the time the loss occurred. Petitioners assert that the applicable law is section 1002[2] and respondent also refers to the same section in his contention that the loss is not recognizable. However, section 1002 as a separate section was repealed by Pub. L. 94-455, sec. 1901(b), 90 Stat. 1764, with respect to taxable years commencing after 1976 and its content was incorporated verbatim into section 1001 as subsection (c). Consequently, the recognition or nonrecognition of a loss on a transaction occurring in 1979, as in this case, is determined by section 1001[3] of which the pertinent portions provide as follows:

> (a) COMPUTATION OF GAIN OR LOSS.--The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the

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[2] Unless otherwise noted, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the year in issue. All rule references are to the Tax Court Rules of Practice and Procedure.

[3] The Tax Reform Act of 1984, Pub. L. 98-369, sec. 421, 98 Stat. 793, added section 1041 to the Internal Revenue Code. This section [applicable to transfers made after July 18, 1984, in tax years ending after such date] provides that no gain or loss will be recognized on a transfer of property from an individual to a former spouse incident to a divorce.

> adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.
>
> (b) AMOUNT REALIZED.--The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. * * *
>
> (c) RECOGNITION OF GAIN OR LOSS.--Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.

In any event, the division of community property pursuant to a divorce decree can result in a nontaxable or a taxable exchange. See Carrieres v. Commissioner, 64 T.C. 959 (1975), affd. per curiam 552 F.2d 1350 (9th Cir. 1977). If in the division, the whole of certain community assets are set aside to one spouse and the whole of the balance of the community assets are set aside to the other spouse and if the aggregate value of the assets set aside to each spouse is equal to one half the total value of the community property, there is no gain or loss to either spouse. In the event, however, that the division results in the whole of certain assets having a value in excess of one-half the total value of the community property being set aside to one spouse, then that spouse will have a gain and conversely the other a loss unless otherwise provided in the Code. Where, as here, a loss is claimed by one of the spouses and the loss is disallowed by respondent, the burden of proof with respect to the overall value of the community property as well as the value of the respective amounts received by the spouses is on the taxpayer claiming the loss. Welch v. Helvering, 290 U.S. 111 (1933).

From the record before us we are unable to determine whether an equal or an unequal division of the community property occurred because first no evidence was presented as to the fair market value of the properties at the time of the divorce. Secondly, William testified that all four properties were encumbered by mortgages but failed to establish what amounts were due on the mortgages when the properties were divided. The record also fails to contain any evidence as to the value of the laundromat business or the cost of supporting the two daughters, both of which have to be considered in determining whether there was a gain or loss in this case. Section 1001(b).

As a result, from the facts presented, we are unable to make a determination that the aggregate fair market value of the property received by William was less than that received by Lana. Consequently, petitioners have failed to carry their burden of proving that respondent was incorrect in his determination that the division of the property under the Agreement was a nontaxable transaction with no loss being realized by petitioners.

Respondent disallowed in its entirety the deduction claimed by petitioners for depreciation of the rental properties. Here again, petitioners have the burden of establishing that respondent's disallowance of the deduction is incorrect and that their deduction of $2,935 is reasonable. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a). In this regard, the record does not contain sufficient relevant and competent evidence from which we can find petitioners' cost or other basis in the depreciable assets, the useful life and salvage value of such assets, and the depreciation allowed or allowable in prior years with respect to such assets. Therefore, we are unable to make a specific finding of the exact amount of their depreciation deduction. However, from the record as a whole it is apparent that from January through his divorce from Lana in September of 1979, William was the owner of one-half of all of the rental properties and for the remainder of the year he was the sole owner of the Biddle Street Apartments and the Haskell Apartments. With the knowledge that some depreciation did occur and being satisfied that some deduction should be allowed we, following the principle of Cohan v. Commissioner, 39 F.2d 540 (1933), as applied in Joyce v. Commissioner, 25 T.C. 13 (1955), and bearing heavily against petitioners, determine that $2,000 is a reasonable allowance for their depreciation deduction in 1979.

Petitioners also claimed deductions from rental income totaling $4,017 which are listed as automobile, gardening, insurance, interest, repairs, supplies, telephone, taxes, and licenses. At trial, petitioners merely asserted that the sums were spent for the items listed and offered no evidence which tended to substantiate the amounts or that they were in fact spent or were expended in connection with the rental properties. Petitioners, therefore, have failed to carry their burden of proof that respondent erred in disallowing the deductions. Welch v. Helvering, supra; Rule 142(a).

Decision will be entered
under Rule 155.

COMPLETED

742-B

Ju 11.7/2:1986-12

T. C. Memo. 1986-12

UNITED STATES TAX COURT

MARY R. WILHELM, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

MARY REED WILHELM, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 15286-82, 23630-83. Filed January 13, 1986.

Stephen Behrends, for the petitioner.[1]

Randall E. Heath, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

PAJAK, Special Trial Judge: These consolidated cases were heard pursuant to the provisions of section 7456 and Rule 180 et seq.[2]

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[1] Mr. Behrends appears for petitioner only on brief filed with the Court subsequent to the trial of this case. Petitioner appeared at trial pro se.

[2] All section references are to the Internal Revenue Code of 1954 as in effect during the taxable years in issue unless, otherwise indicated. All rule references are to the Tax Court Rules of Practice and Procedure.

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Respondent determined deficiencies in petitioner's 1979 and 1980 Federal income taxes in the amounts of $3,778 and $2,122, respectively. After granting respondent's motion for partial summary judgment made at trial[3] and concessions by the parties,[4] the only issue remaining for decision is whether petitioner is entitled to a $16,000 theft loss deduction in 1980.

Petitioner resided in La Habra, California, at the time she filed her petition in Docket No. 15286-82 and Myrtle Point, Oregon, at the time she filed her petition in Docket No. 23630-83.

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[3] In Wilhelm v. Commissioner, T.C. Memo. 1983-274 (Wilhelm I), this Court in considering petitioner's taxable year 1977 ruled that this petitioner's testimony and the various lists and miscellaneous receipts submitted by her to substantiate a claimed theft loss in 1979 were simply insufficient for the Court to make a finding as to even a reasonably accurate estimate regarding the lesser of the cost or fair market value of the items stolen and concluded that petitioner had failed to prove her entitlement to a carryback to 1977. She also claimed home office deductions in 1977 and 1978 and the Court in Wilhelm I ruled that the college where petitioner taught and performed health care duties was the focal point of her employment activities, not her home office, and ruled against her on the home office issue. In this case, petitioner again reiterated her claims for the same deductions for home office expenses in 1978 and 1979 and the same theft loss as was litigated in Wilhelm I. Accordingly, at the trial of this case we held that petitioner was collaterally estopped from raising these issues again and granted respondent's motion for partial summary judgment under Rule 121.

[4] Petitioner on brief conceded virtually all of the issues tried and we see no reason to discuss them in this opinion. Respondent on brief conceded petitioner is entitled to $330 as an employee business expense deduction for 1979. Some other adjustments are automatic based on the resolution of other issues.

In 1980, petitioner, a registered nurse and college instructor, was considering retirement. As part of her retirement plans, petitioner intended to invest in a clinic in Clear Lake, California, with other semi-retired doctors and nurses.

According to petitioner's testimony, she planned to drive to Clear Lake to investigate the proposed investment in the clinic. Anticipating that she would conclude the transaction on that trip, petitioner claimed that she placed $16,000 in cash in the glove compartment of her Cadillac.

On the day of the planned trip, petitioner was involved in an automobile accident. As a result of injuries sustained in that accident, petitioner said she was taken to a hospital for care and treatment. When she was eventually able to return to her car, petitioner testified that the $16,000 was no longer in the glove compartment. On her 1980 Federal income tax return, petitioner claimed a theft loss deduction of $16,000 without deducting the $100 floor required by section 165(h). Respondent disallowed the theft loss deduction for lack of substantiation.

Petitioner bears the burden of proving that respondent's determination is wrong. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a). After reviewing this record, we conclude that petitioner simply failed to meet this burden.

Despite ample time to procure the necessary proof to substantiate her claimed theft loss deduction, petitioner failed to produce any documentation that would enable us to decide this case in her favor. Petitioner's only support for her position was her testimony which we found vague, disjointed, and inconsistent. For example, petitioner stated that after the automobile accident, she rented a car to drive up to Clear Lake because her Cadillac had been "totaled." From the record and petitioner's statements it appears that the accident and the subsequent trip in the rental car took place in September and October of 1980. However, according to petitioner's testimony, she claimed the cost of renting that car as a business expense on her 1979 Federal income tax return which was filed on April 15, 1980, approximately five months before the car accident purportedly occurred.

This discrepancy casts serious doubt on the credibility of petitioner's testimony. We are not required to accept testimony as gospel, even though it is not controverted; we are entitled to take into account whether it is improbable, unreasonable, or questionable. Simon v. Commissioner, T.C. Memo. 1981-198. It is clear to us that petitioner's testimony alone simply does not provide a sufficient basis to allow us to grant petitioner's claimed deduction. Our evaluation of her testimony is founded upon "the ultimate task of a trier of the facts -- the distillation of truth from falsehood which is the daily grist of judicial life." Diaz v. Commissioner, 58 T.C. 560, 564 (1972). Accordingly, respondent is sustained on this issue.

Decision will be entered under Rule 155 in Docket No. 15286-82.

Decision will be entered for the respondent in Docket No. 23630-83.

742-B

COMPLETED

Ju 11.7/2: 1986-13

T. C. Memo. 1986-13

UNITED STATES TAX COURT

LEONARD A. LUTZ, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 23618-83. Filed January 13, 1986.

P has totally and willfully failed to produce documents despite a specific order of this Court directing him to do so. Held, P's failure constitutes a default and judgment therefor is appropriate respecting the income tax deficiencies and the additions to the tax under sec. 6654, I.R.C. 1954. Rule 104(c)(3), Tax Court Rules of Practice and Procedure. Held further, P is liable for the additions to tax for fraud under sec. 6653(b), I.R.C. 1954. Rule 104(c)(1), Tax Court Rules of Practice and Procedure. Durovic v. Commissioner, 84 T.C. 101 (1985), followed.

Leonard A. Lutz, pro se.

Russell F. Kurdys and Willie E. Armstrong, Jr., for the respondent.

MEMORANDUM OPINION

CANTREL, Special Trial Judge: This case is before the Court on respondent's Motion to Impose Sanctions [under Rule 104(c)][1]

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[1] All Rule references are to the Tax Court Rules of Practice and Procedure.

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filed on August 15, 1985.[2]

Respondent, in his notice of deficiency issued to petitioner on May 19, 1983, determined deficiencies in petitioner's Federal income tax and additions to the tax for the taxable calendar years 1979 through 1981 in the following respective amounts:

		Additions to Tax, I.R.C. 1954[3]	
Years	Income Tax	Section 6653(b)	Section 6654
1979	$1,583.98	$ 791.99	$ 65.84
1980	2,261.28	1,130.64	144.07
1981	1,465.65	732.83	112.32

The adjustments to income as determined by respondent in his deficiency notice are:

	1979	1980	1981
Salaries & Wages Unreported	$1,970.00	$2,514.28	$ 550.00
Rents Unreported	2,043.00	2,160.00	2,160.00
Distributive share of partnership ordinary income unreported	1,230.31	5,862.18	4,517.02
Capital Gains Unreported	3,797.70	-0-	853.12
Exemption	-0-	-0-	(1,000.00)
	$9,041.01	$10,536.46	$7,080.14

Petitioner resided at 202 Sylvan Heights Drive, Sylvania, Georgia on the date his timely petition was filed. He filed no Federal income tax returns with the Internal Revenue Service for the years at bar.[4]

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[2] This case was assigned pursuant to sec. 7456(d)(3), Internal Revenue Code of 1954, as amended, and Delegation Order No. 8 of this Court, 81 T.C. XXV (1983).

[3] All section references are to the Internal Revenue Code of 1954, as amended.

[4] The 1979 Form 1040, which petitioner submitted to the Internal Revenue Service on May 21, 1980 and which was completely devoid
(footnote continued)

At paragraph 4 of his petition filed on August 12, 1983 petitioner recites--"I do not believe I owe any of the above."[5]

Respondent filed his answer on February 27, 1984 and, as stated earlier, petitioner filed his reply on June 14, 1984, on which date the pleadings were closed. More than 30 days thereafter respondent commenced discovery. See Rules 34, 36, 38 and 70(a)(2).

This case has had quite a history preceding the invocation of discovery. Since that matter is not pertinent to our present inquiry it will not be discussed. Suffice it to say petitioner is no stranger to this Court. He has been here before with his spouse (who currently is before the Court on an identical motion to that we consider here at docket No. 23619-83) in the case designated docket No. 9211-81. There, when they failed to appear for trial, their case was dismissed for failure to properly prosecute and decision was entered embracing a 1978 income tax deficiency on November 3, 1982.

(footnote continued from previous page)
of information concerning income, did not constitute a valid Federal income tax return. Jarvis v. Commissioner, 78 T.C. 646, 652-655 (1982), and cases cited therein. At paragraph 6(b) of his Reply to respondent's Answer filed on June 14, 1984 petitioner admits that he filed no Federal income tax return for 1980 or 1981.

[5] This is the sum and substance of petitioner's case. We observe, however, that he has not placed the income tax deficiencies at dispute. He disputes only the additions to the tax under secs. 6653(b) and 6654.

Respondent, by and through his motion, seeks dismissal of this case and entry of decision for the income tax deficiencies and all of the additions to the tax determined in his deficiency notice.

On December 18, 1984 respondent, pursuant to Rule 72, served on petitioner an 11 paragraph document request. A review of those requests reveals that they seek documents which are highly relevant and material to the issues at dispute in this case.

The purpose of the pleadings and discovery is to give the parties and the Court fair notice of the matters in controversy and the basis for their respective positions. See Rule 31(a) and Kabbaby v. Commissioner, 64 T.C. 393, 394 (1975). All of the pertinent and relevant facts necessary to the disposition of a case should see the light of day prior to the trial of a case.

The basic purpose of discovery is to reduce surprise by providing a means for the parties to obtain knowledge of all relevant facts in sufficient time to perfect a proper record for the Court if a case must be tried. "For purposes of discovery, the standard of relevancy is liberal. Rule 70(b) permits discovery of information relevant not only to the issues of the pending case, but to the entire 'subject matter' of the case." Zaentz v. Commissioner, 73 T.C. 469, 471 (1979).

When petitioner totally failed to respond to respondent's discovery request, respondent submitted a Motion to Compel Compliance Therewith, which the Court filed on January 22, 1985.[6]

By Order dated February 12, 1985, a copy of which was served on the parties by the Court on February 14, 1985, respondent's Motion to Compel was granted and petitioner was advised therein, in pertinent part, as follows:

> ORDERED that respondent's above-referenced motion to compel is granted in that petitioner shall, on or before May 1, 1985, produce to counsel for respondent those documents requested in respondent's request for production of documents served on petitioner on December 18, 1984.[[7]] It is further
>
> ORDERED that in the event petitioner does not fully comply with the provisions of this order, this Court will be inclined to impose sanctions pursuant to Tax Court Rule 104, which may include dismissal of this case and entry of a decision against petitioner.

Petitioner did not produce the documents as directed by this Court and it appears he had no intention of doing so for in a letter dated May 22, 1985 to respondent's District Counsel at Pittsburgh, Pennsylvania he states--

> Having spoken to you on the phone and understanding that I have one of two choices (i.e. take evidence in to be used against myself OR refuse to go in at all) I have chosen not to go in since this would violate my rights under the 5th amendment to the Constituion (sic) of the United States of America.

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[6] Respondent served a copy of his motion on petitioner on January 16, 1985.

[7] Petitioner was given more than the usual time to produce the requested documents since he advised the Court that he had recently moved, his spouse was to undergo surgery and his two grade school children needed supervision. Petitioner's time to produce was further extended, at his request, to June 3, 1985.

> I assume this means that the court will immediately deny me any farther (sic) hearing in this matter, but this cannot be helped in the light of those rights which are mine under the Constitution.

On August 15, 1985 respondent filed the motion we now consider. A copy of that motion together with a copy of a Notice of Hearing calendaring respondent's motion for hearing at Washington, D.C. on September 18, 1985 were served on petitioner on August 19, 1985. When the case was called on September 18, 1985 petitioner did not appear, no response to respondent's motion was filed nor did he comply with our discovery order.

Our Rules of Practice and our orders mean exactly what they say and we intend that they be complied with. *Rosenfeld v. Commissioner*, 82 T.C. 105, 111 (1984); *Odend'hal v. Commissioner*, 75 T.C. 400, 404 (1980); *Branerton Corp. v. Commissioner*, 61 T.C. 691, 692 (1974).

Although given more than an ample opportunity to comply with our Rules and a specific order of this Court petitioner has not done so and there is not one valid reason extant in this record to explain his total failure to comply. He has, in essence, ignored and defied our order of February 12, 1985, and, by his inexcusable conduct, shown complete and utter disrespect for our Rules and an order of this Court. Indeed, petitioner's total failure to act has worked to his detriment. On this record, we find petitioner's absolute failure to comply with our order to be willful.

Petitioner's due process rights have not been abrogated or abridged here. Ginter v. Southern, 611 F.2d 1226 (8th Cir. 1979); Cupp v. Commissioner, 65 T.C. 68 (1975), affd. in an unpublished opinion 559 F.2d 1207 (3rd Cir. 1977). His general assertion that his Fourth and Fifth Amendment rights have been violated is wholly frivolous. See Rechtzigel v. Commissioner, 79 T.C. 132, 136-139 (1982), affd. per curiam 703 F.2d 1063 (8th Cir. 1983). In Edwards v. Commissioner, 680 F.2d 1268, 1270 (9th Cir. 1982), the Court said--

> Appellant's fourth amendment claim is without foundation and utterly devoid of merit. Requiring taxpayers, who institute civil proceedings protesting deficiency notices, to produce records or face dismissal constitutes no invasion of privacy or unlawful search and seizure.[8]

As we view this record, respondent's discovery request sought documents highly relevant and material to the issues at dispute. Nowhere in this record does petitioner argue to the contrary. Nonetheless, he made no attempt to comply with those requests despite a specific order of this Court directing him to do so.

Rule 104, respecting enforcement actions and sanctions, provides in pertinent part as follows--

> (c) Sanctions: If a party * * * fails to obey an order made by the Court with respect to the provisions of Rule * * * 72 * * * the Court may make such orders as to the failure as are just, and among others the following:

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[8] See Ricket v. Commissioner, 773 F.2d 1214 (11th Cir. 1985), where the Court rejected a Fifth Amendment claim as frivolous. We observe that venue on appeal of this case lies in the United States Court of Appeals for the Eleventh Circuit. See also, Hallowell v. Commissioner, 744 F.2d 406, 408 (5th Cir. 1984).

* * *

> (3) An order striking out pleadings or parts thereof, or staying further proceedings until the order is obeyed, or dismissing the case or any part thereof, or rendering a judgment by default against the disobedient party.

Rule 104(a) and (c) provide various sanctions for failure to respond to discovery requests and for failure to comply with discovery orders. The sanctions for each are the same and are enumerated in Rule 104(c). Where no discovery order is outstanding dismissal is appropriate only upon total failure to respond to discovery requests. However, where a party fails to comply with a Court order dismissal may be appropriate even though there has been a partial response. Dusha v. Commissioner, 82 T.C. 592, 602-604 (1984), which was reviewed by the Court. Here, petitioner has, without justification, totally and willfully refused to respond to respondent's discovery request in spite of a specific order of this Court directing him to do so.

Among the sanctions available, dismissal is one of the most severe and should not be ordered indiscriminately. Dusha v. Commissioner, supra at 605. Nevertheless, it must be available under appropriate circumstances not merely to penalize the party for failure to comply with a Court order but also to deter other taxpayers from engaging in similar conduct. Dusha v. Commissioner, supra at 605-606; National Hockey League v. Met. Hockey Club, 427 U.S. 639, 643 (1976).

Dismissal is proper for failure to comply with this Court's discovery orders where such failure is due to willfulness, bad faith or other fault of the party. Dusha v. Commissioner, supra at 604; Societe Internationale v. Rogers, 357 U.S. 197, 212 (1958). Where the evidence requested is material, failure to produce it constitutes an admission of the lack of merit in the party's position. Dusha v. Commissioner, supra at 605; Hammond Packing Co. v. Arkansas, 212 U.S. 322 (1909).

In the circumstances of this case we conclude that petitioner's persistent, stubborn and, thus, unwarranted and unjustified conduct constitutes a default and that dismissal of this case respecting the income tax deficiencies and the additions to the tax under section 6654 for failure to comply with our rules and a specific order of this Court is, albeit a severe sanction, appropriate under Rule 104(c)(3). See Steinbrecher v. Commissioner, 712 F.2d 195 (5th Cir. 1983), affg. T.C. Memo. 1983-12; Miller v. Commissioner, 741 F.2d 198 (8th Cir. 1984), affg. per curiam an order of dismissal and decision of this Court; Hart v. Commissioner, 730 F.2d 1206 (8th Cir. 1984), affg. per curiam an order of dismissal and decision of this Court; Rechtzigel v. Commissioner, supra; McCoy v. Commissioner, 696 F.2d 1234 (9th Cir. 1983), affg. 76 T.C. 1027 (1981); Eisele v. Commissioner, 580 F.2d 805 (5th Cir. 1978).[9]

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[9] See also, Keating v. Commissioner, T.C. Memo. 1985-312; Hollander v. Commissioner, T.C. Memo. 1985-184; Delaney v. Commissioner, T.C. Memo. 1985-73; Baranski v. Commissioner, T.C.
(footnote continued)

Next, we turn our consideration to the additions to the tax under section 6653(b). Rule 104(c) provides as a sanction that we may make "[a]n order that the matters regarding which the order was made or any other designated facts shall be taken to be established for the purposes of the case in accordance with the claim of the party obtaining the order."[10]

Respondent has the burden of proving fraud by clear and convincing evidence, and he may carry his burden by relying on facts deemed established by reason of a Court order. Rechtzigel v. Commissioner, supra at 139-143; Marcus v. Commissioner, 70 T.C. 562, 571-573 (1978), affd. without published opinion 621 F.2d 439 (5th Cir. 1980); section 7454(a) and Rule 142(b). Moreover, it is clear that, as a sanction for the total and willful failure to comply with our Order of February 12, 1985, we may deem established for purposes of this case certain facts, including facts pertaining to the additions to the tax for fraud.

(footnote continued from previous page)
Memo. 1984-639; Kuhn v. Commissioner, T.C. Memo. 1984-638; Romano v. Commissioner, T.C. Memo. 1984-568; Burton v. Commissioner, T.C. Memo. 1984-99; Douglas v. Commissioner, T.C. Memo. 1983-786, affd. without published opinion 754 F.2d 373 (6th Cir. 1984); Kuever v. Commissioner, T.C. Memo. 1983-58; Murmes v. Commissioner, T.C. Memo. 1983-55; Riehle v. Commissioner, T.C. Memo. 1982-141; Farley v. Commissioner, T.C. Memo. 1981-606; Gaar v. Commissioner, T.C. Memo. 1981-595.

[10] We wish to emphasize at this point that petitioner, in his reply filed on June 14, 1984, admits that he received the adjustments to income set forth in the proceeding schedule and that he did not report any of those amounts on any Federal income tax return for the years at bar.

Durovic v. Commissioner, 84 T.C. 101, 118-119 (1985).[11] By and through our Order dated December 18, 1985 and as a sanction we deemed established for purposes of this case the affirmative allegations contained in paragraph 6(a) through (r) of respondent's answer. The facts which we have deemed established are sufficient for respondent to carry his burden of proof and to show that there was a fraudulent underpayment of taxes by petitioner.

An appropriate order and decision will be entered.

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[11] See and compare Hartman v. Commissioner, T.C. Memo. 1985-482.

COMPLETED 742-B
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Ju 11.7/2:1986-14

T. C. Memo. 1986-14

UNITED STATES TAX COURT

CARL M. O'DONNELL and ROBERTA M. O'DONNELL, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 27563-82. Filed January 13, 1986.

Held: Personal service income assigned by petitioners to an "Express Equity Pure Trust" constitutes income to petitioners. Held further, petitioners are not entitled to depreciation and business expense deductions for an automobile leased to the trust. Held further, petitioners are liable for an addition to tax pursuant to section 6653(a).

Carl M. O'Donnell, pro se.

Christine Colley, for the respondent.

ORIGINAL

MEMORANDUM FINDINGS OF FACT AND OPINION

WHITAKER, Judge: Respondent determined a deficiency in petitioners' 1978 Federal income tax in the amount of $2,949, together with an addition to tax of $147.45 pursuant to section 6653(a).[1] The issues presented for decision are:

(1) Whether personal service income assigned by petitioners to an "Express Equity Pure Trust" is taxable to petitioners individually;

(2) whether petitioners are entitled to depreciation and business expense deductions for an automobile leased to the trust; and

(3) whether petitioners are liable for an addition to tax under section 6653(a).

Some of the facts have been stipulated and are so found. The stipulation of facts and attached exhibits are incorporated herein by reference. For convenience, our Findings of Fact and Opinion are combined.

At the time of filing their petition in this case, petitioners resided in Bedford, Massachusetts. On September 6, 1975 petitioners Carl M. O'Donnell (O'Donnell) and Roberta M. O'Donnell (Mrs. O'Donnell) signed a "Declaration of Trust" purporting to create the Carl M. O'Donnell Equity Trust (Trust). The Declaration of Trust designated O'Donnell as the grantor-creator and Mrs. O'Donnell and Carl Harmon (Harmon) as trustees of the Trust. The "Trustee's Declaration of Purpose" used the following now familiar language:

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[1] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue, and all rule references are to the Tax Court Rules of Practice and Procedure.

> THE DECLARED PURPOSE OF THE TRUSTEES OF THIS TRUST shall be to accept rights, title and interest in and to real and personal properties, whether tangible or intangible, conveyed by THE CREATOR HEREOF AND GRANTOR HERETO to be the corpus of THIS TRUST. Included therein is the exclusive use of his lifetime services and All of his EARNED REMUNERATION ACCRUING THEREFROM, from any current source whatsoever, so that **Carl M. O'Donnell** can maximize his lifetime efforts through the utilization of his Constitutional Rights; for the protection of his family in the pursuit of his happiness through his desire to promote the general welfare, all of which **Carl M. O'Donnell** feels he will achieve because they are sustained by his RELIGIOUS BELIEFS.

To facilitate the consolidation of their assets in the Trust, Mrs. O'Donnell executed a quit-claim deed to O'Donnell on September 6, 1975. The deed granted to O'Donnell a parcel of land located in Portland, Maine together with all buildings and improvements thereon. The deed also purported to convey "certain of Roberta M. O'Donnell other real and personal properties, included therein are her dower, homestead or other marital rights, if any, to be conveyed simultaneously with this conveyance."

On September 8, 1975 O'Donnell executed a quit-claim deed to Mrs. O'Donnell and Harmon as trustees for the Trust. The deed granted to the trustees the parcel of land located in Portland, Maine, together with all buildings and improvements located thereon. The deed also purported to convey "all dower, homestead or other marital rights, if any" possessed by O'Donnell. Thus, in conjunction with Mrs. O'Donnell's deed of September 6, all of petitioners' interests in the Portland, Maine parcel, together with their dower, homestead, or other marital rights, were transferred to the Trust.

On October 6, 1977 O'Donnell leased to the Trust a 1977 Chevrolet automobile. The lease agreement was on a preprinted form bearing the logo of Educational Scientific Publishers. The lease provided for payment by the Trust as lessee to O'Donnell as lessor of $1.00, plus a monthly rental sufficient to retire any outstanding lien against the vehicle. The lease further provided that the Trust was liable as lessee for the titling, registration, licensing, insurance, oil, gas, taxes, penalties, fines, and maintenance expenses associated with operation of the vehicle.

Petitioners' 1978 Federal income tax return included W-2 forms issued to petitioners in the amount of $22,441. Petitioners deducted a net loss of $977 from the rental of the automobile. Additionally, petitioners deducted a "nominee payment" to the O'Donnell Trust of $22,441. The nominee payment was reduced, however, by a "consulting" fee of $8,162, ostensibly representing compensation paid by the trust to petitioners. Thus, petitioners' net deduction for nominee payments was $14,279. After these adjustments, petitioners reported taxable income of $7,185.

Petitioners filed a Fiduciary Income Tax Return on behalf of the Trust for the taxable year 1978. Petitioners included $22,441 in the Trust's income under the designation "Contract/Nominee Income." This amount exactly equaled the $22,441 shown on petitioners' W-2 forms and included on their joint return. Petitioners' then deducted $22,341 from the

Trust's income for housing, utilities, medical and dental expenses, auto leasing expenses, consulting fees, and assorted maintenance and supply expenses. The remaining $100 of income was claimed as an exemption for filing a final return.

The first issue for decision is whether the personal service income transferred to the Trust is taxable to the Trust or to petitioners. Petitioners have the burden of proving that the deficiencies determined by respondent are incorrect. Welch v. Helvering, 290 U.S. 111, 115 (1933); Rule 142(a). Respondent contends that petitioners' assignment of income does not operate to shift the incidence of taxation from them to the Trust. In view of the long series of cases concerning similar family trust arrangements, all of which have held such assignments of income to be ineffective, there is no doubt that respondent is correct. Gran v. Commissioner, 664 F.2d 199 (8th Cir. 1981), affg. T.C. Memo. 1980-558; Vnuk v. Commissioner, 621 F.2d 1318 (8th Cir. 1980), affg. T.C. Memo. 1979-164; Vercio v. Commissioner, 73 T.C. 1246 (1980); Wesenberg v. Commissioner, 69 T.C. 1005 (1978). It is an elementary principle of our tax system that individuals cannot escape taxation by diverting income to some other entity through contractual arrangements. United States v. Basye, 410 U.S. 441 (1973); Lucas v. Earl, 281 U.S. 111 (1930). Accordingly, the amounts shown on petitioners' individual tax returns for 1978 as nominee payments to the Trust are treated as income to petitioners.

We recognize that in a typical family trust arrangement, the taxpayer's income is transferred directly to the trust by the taxpayer's employer. In this instance, however, petitioners included their wages in their personal income and attempted to deduct the income assigned to the Trust as a "nominee payment." In O'Donnell v. Commissioner, 726 F.2d 679 (11th Cir. 1984), the Eleventh Circuit affirmed a partial summary judgment by this Court against O'Donnell's brother in a case involving a family trust virtually indistinguishable from the one before us. As in O'Donnell, we find (1) that petitioners received the money paid into the Trust, and (2) that the Trust had no charitable attributes or any other attributes that might give rise to a deduction. Thus, there is no validity to petitioners' claimed deduction for nominee payments made to the Trust.

We must next decide whether petitioners are entitled to depreciation and business expense deductions for an automobile leased to the Trust. Petitioners have presented no evidence other than the lease agreement supporting these deductions. We agree with respondent that petitioners have failed to demonstrate that their activities constituted a trade or business or that the automobile was held by petitioners for the production of income. Though leased to the Trust, the automobile was used by petitioners. As such, its maintenance constitutes a nondeductible personal living expense pursuant to section 262. Thus, respondent's elimination of rental income and disallowance of rental expense deductions is sustained.

Finally, we must decide whether petitioners are liable for an addition to tax under section 6653(a). Section 6653(a) provides for an addition to tax of 5 percent of the underpayment "[i]f any part of any underpayment * * * of any [income] tax * * * is due to negligence or intentional disregard of rules and regulations." Petitioners have the burden of proving that the addition to tax determined by respondent in the notice of deficiency does not apply. Bixby v. Commissioner, 58 T.C. 757, 791 (1972); Rule 142(a).

The imposition of additions to tax for negligence has been upheld time and again in cases involving the use of family trusts. E.g., Vnuk v. Commissioner, supra; Vercio v. Commissioner, supra; Wesenberg v. Commissioner, supra. Petitioners knew, or should have known if they had sought independent tax advice, that they could not avoid taxation by assigning income and property to this type of family trust. We have previously mentioned several cases holding assignments of income to such trusts ineffective and holding individuals liable under the grantor trust provisions. A number of cases have also held similar family trust arrangements to be mere shams devoid of economic reality. See, e.g., Markosian v. Commissioner, 73 T.C. 1235 (1980); Basham v. Commissioner, T.C. Memo. 1980-545; Antonelli v. Commissioner, T.C. Memo. 1980-544.

Petitioners contend that they established the Trust based on information provided by the attorney promoting the Trust. This information included a prospectus published by Educational

Scientific Publishers which petitioners submitted as their brief. As in previous cases, we find it appropriate here to reiterate what we said in Harris v. Commissioner, T.C. Memo. 1981-46:

> In our view, a prudent individual would have endeavored to obtain independent legal and tax advice before attempting to make such an all-encompassing (though ineffective) disposition of all of his or her assets, including, as here, the very means of livelihood. To anyone (and we would include petitioners) not incorrigibly addicted to the "free lunch" philosophy of life, the entire scheme had to have been seen as a wholly transparent sham. * * *

Accordingly, we hold that petitioners are liable for the addition to tax under section 6653(a) as determined by respondent in the notice of deficiency.

To reflect the foregoing,

Decision will be entered

for the respondent.

MPLETED

Ju 11.7/2:1986-15

T. C. Memo. 1986-15

UNITED STATES TAX COURT

ROBERT JACKSON, Petitioner *v* COMMISSIONER
OF INTERNAL REVENUE, Respondent

Docket No. 442-85. Filed January 13, 1986.

Held, allegations deemed admitted under Rule 37(c), Tax Court Rules of Practice and Procedure, are sufficient to sustain an income tax deficiency and an addition to the tax under sec. 6654, I.R.C. 1954, and R's motion for summary judgment on those issues is granted. *Held further*, allegations deemed admitted under Rule 37(c), Tax Court Rules of Practice and Procedure, are sufficient to satisfy R's burden of proving fraud, and R's motion for summary judgment on that issue is granted. *Doncaster v. Commissioner*, 77 T.C. 334 (1981), followed.

ORIGINAL

Robert Jackson, pro se.

Thaddeus G. Wozny and Will E. McLeod, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

FEATHERSTON, Judge: This case was assigned to Special Trial Judge Francis J. Cantrel for the purpose of hearing, consideration, and ruling on respondent's Motion for Summary Judgment filed herein.[1] After a review of the record, we agree with and adopt his opinion, which is set forth below.

OPINION OF THE SPECIAL TRIAL JUDGE

CANTREL, Special Trial Judge: This case is before the Court on respondent's Motion for Summary Judgment filed on October 21, 1985, pursuant to Rule 121, Tax Court Rules of Practice and Procedure.[2]

Respondent, in his notice of deficiency issued to petitioner on October 29, 1984, determined a deficiency in petitioner's Federal income tax and additions to the tax for the taxable calendar year 1981 in the following respective amounts:

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[1] This case was assigned pursuant to sec. 7456(d)(4), Internal Revenue Code of 1954, as amended, and Delegation Order No. 8, 81 T.C. XXV (1983).

[2] All Rule references are to the Tax Court Rules of Practice and Procedure.

		Additions to Tax, I.R.C. 1954[3]	
Year	Income Tax	Section 6653(b)	Section 6654
1981	$9,656.00	$4,828.00	$739.00

The adjustments to income determined by respondent in computing the deficiency are as follows:

Wages	$29,183.00
Standard Deduction/Zero Bracket Amount not allowed[4]	1,700.00
Exemption	(1,000.00)
	$29,883.00

Petitioner resided at 738 Hemlock Street, Brooklyn, New York on the date his petition was filed. He filed no 1981 Federal income tax return with the Internal Revenue Service.

The procedural sequence of events resulting in this case began with the issuance of the notice of deficiency on October 29, 1984. A timely petition was filed with this Court on January 7, 1985. See section 6213. Respondent filed his answer on March 8, 1985, wherein at paragraph 8.a. through i., he affirmatively pleaded as to petitioner's wage income, the addition to the tax under section 6654, and the addition to the tax under section 6653(b).

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[3] All section references are to the Internal Revenue Code of 1954, as amended.

[4] This determination was made on the basis of petitioner's filing status as "married filing separately" since his spouse filed a separate return for 1981 itemizing deductions and petitioner filed no 1981 return claiming itemized deductions under sec. 3(a)(4). See also, sec. 63(e).

When no reply was filed respondent, on May 23, 1985, filed a motion for entry of order that undenied allegations in answer be deemed admitted.[5] On May 28, 1985, the Court served on petitioner a notice of filing of motion for order under Rule 37 wherein petitioner was given until June 17, 1985 in which to file a reply to respondent's answer. When no reply was filed, the Court, by order dated June 27, 1985, a copy of which was served on the parties by the Court on the following day, granted respondent's motion and deemed admitted for purposes of this case the affirmative allegations of fact set forth in paragraph 8.a. through i. of respondent's answer. On promulgation of our order the pleadings herein were closed. Respondent's motion was filed more than 30 days after the pleadings were closed. See Rules 34, 36, 37, 38 and 121.

Respondent, on October 21, 1985, filed the motion we now consider together with a Memorandum of Law and an affidavit. Copies of those documents together with a copy of a Notice of Hearing, calendaring respondent's motion for hearing at Washington, D.C. on December 4, 1985, were served on petitioner by the Court by certified mail on November 4, 1985. Those documents were returned to the Court when petitioner failed to claim them despite twice being notified by the U.S. Postal

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[5] Respondent served a copy of his motion on petitioner at the address provided in the petition on May 22, 1985.

Service to pick them up.[6] As a consequence, when the case was called on December 4, 1985, petitioner did not appear nor did he file a response to respondent's motion. Counsel for respondent appeared and presented argument, at the conclusion of which we took respondent's motion under advisement.

The following findings of fact are based on the record as a whole, allegations in respondent's answer admitting allegations in the petition, and those facts in respondent's answer deemed admitted by our June 27, 1985 order.

FINDINGS OF FACT

During 1981 petitioner was employed by the New York City Transit Authority (Transit Authority). For services performed for the Transit Authority he earned wages in the aggregate amount of $29,183.21. Those wages were paid to petitioner in his individual capacity and not as an agent of any church or religious organization. They were paid by the Transit Authority to petitioner by checks made directly payable to petitioner with no restrictions on the use of said checks.

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[6] In our view, petitioner's failure to receive these documents is due solely to his refusal to pick them up. The address we used on that mailing is the same as petitioner reported on his petition and appearing on the Court's docket sheet appertaining to this case. The Court's records further reflect that petitioner has received all other papers filed in this case which were served at that address. Moreover, if petitioner has changed his address he has not so notified the Court as required by our Rules of Practice. See Rule 21(b)(4).

Petitioner purports to have been a minister of the Life Science Church during 1981 and he asserts that by reason of his alleged vow of poverty, his secular wages are exempt from taxation.[7] The services which petitioner performed for the Transit Authority did not include any religious duties.

Petitioner fraudulently and with intent to evade tax filed a false Form W-4 with his employer claiming 50 exemptions for the purpose of avoiding withholding of Federal income tax from his wages. He fraudulently and with intent to evade tax filed no Form 1040, or any other form purporting to be a return for the taxable year 1981, and he paid no Federal income tax for said taxable year.

Petitioner fraudulently and with intent to evade tax failed to report taxable income in the amount of $29,183 for 1981 and he failed to pay an income tax liability for said year in the amount of $9,656. A part of the underpayment of tax for 1981 is due to fraud with intent to evade tax.

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[7] Such assertions have been consistently rejected by the courts. See, for example, McGahen v. Commissioner, 76 T.C. 468 (1981), affd. without published opinion 720 F.2d 664 (3d Cir. 1983); Long v. Commissioner, T.C. Memo. 1985-371, appeal dismissed (2d Cir. 1985) (we observe that venue on appeal of this case lies in the United States Court of Appeals for the Second Circuit); Ford v. Commissioner, T.C. Memo. 1984-501, on appeal (2d Cir., Apr. 4, 1985); Brennan v. Commissioner, T.C. Memo. 1984-500, affd. 774 F.2d 570 (2d Cir. 1985); Wert v. Commissioner, T.C. Memo. 1984-499, affd. 774 F.2d 570 (2d Cir. 1985); Young v. Commissioner, T.C. Memo. 1981-109, affd. without published opinion 673 F.2d 1334 (7th Cir. 1981); Lynch v. Commissioner, T.C. Memo. 1980-464.

OPINION

Rule 121 provides that a party may move for summary judgment upon all or any part of the legal issues in controversy so long as there are no genuine issues of material fact. Rule 121(b) provides for summary adjudication if the pleadings, answers to interrogatories, depositions, admissions, and any other acceptable materials, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that a decision may be rendered as a matter of law. The burden of proving that there is no genuine issue of material fact is on the moving party. Adickes v. Kress & Co., 398 U.S. 144, 157 (1970); Espinoza v. Commissioner, 78 T.C. 412, 416 (1982).

Material factual allegations in the answer respecting respondent's income tax deficiency determination and the addition to the tax under section 6654 have been deemed admitted by our order of June 27, 1985. On the basis thereof we conclude there are no genuine issues of material fact with respect thereto and respondent is entitled to a judgment respecting those determinations as a matter of law.

Next, we turn our consideration to the addition to the tax under section 6653(b). The burden of proof with respect to the fraud issue is upon respondent to prove, by clear and convincing evidence, that an underpayment exists and that some part of such underpayment of tax was due to fraud with an intent to evade tax, section 7454(a); Rule 142(b); Stratton v. Commissioner, 54 T.C. 255 (1970); Imburgia v. Commissioner, 22 T.C. 1002 (1954). That burden can be satisfied by respondent through the undenied facts deemed admitted under Rule 37(c). *Doncaster v. Commissioner*, 77 T.C. 334 (1981) (a Court reviewed opinion); *Marcus v. Commissioner*, 70 T.C. 562 (1978), affd. in an unpublished opinion 621 F.2d 439 (5th Cir. 1980); *Gilday v. Commissioner*, 62 T.C. 260 (1974).[8] Here, material factual allegations in the answer with respect to fraud with intent to evade tax have been deemed to be admitted by our order of June 27, 1985. In our view, those findings of fact clearly and convincingly establish that in the taxable year 1981 an underpayment of tax exists and a part of the underpayment is due to fraud with an intent to evade tax.

In addition to those facts deemed admitted by our order of June 27, 1985 this record contains a complete copy of the notice of deficiency, the petition, the answer and respondent's affidavit. Respondent has amply demonstrated to our satisfaction that there is no genuine issue as to any material fact present in this record, and, thus, that respondent is entitled to a decision as a matter of law. In such posture, summary judgment is a proper procedure for disposition of this case. Respondent's Motion for Summary Judgment will be granted in every respect.

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[8] See also *Keeton v. Commissioner*, T.C. Memo. 1985-599; *Behrman v. Commissioner*, T.C. Memo. 1985-99; *D'Angelico v. Commissioner*, T.C. Memo. 1985-78; *Estate of Hopkins v. Commissioner*, T.C. Memo. 1985-75; *Shulman v. Commissioner*, T.C. Memo. 1985-70; *Buiatti v. Commissioner*, T.C. Memo. 1984-523; *Wadsworth v. Commissioner*, T.C. Memo. 1983-438; *Poe v. Commissioner*, T.C. Memo. 1983-149; *Hahn v. Commissioner*, T.C. Memo. 1982-717; *Coastal Shipping Co. v. Commissioner*, T.C. Memo. 1981-382; *Burnette v. Commissioner*, T.C. Memo. 1981-381; *Nielson v. Commissioner*, T.C. Memo. 1980-453. See and compare *Marshall v. Commissioner*, 85 T.C. 267, 272-273 (1985).

An appropriate order and
decision will be entered.

COMPLETED

742-B

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Ju 11.7/2:1986-16

T. C. Memo. 1986-16

UNITED STATES TAX COURT

GERALD SCHWERM AND JOYCE J. SCHWERM, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 1214-81. Filed January 13, 1986.

Petitioner-wife received a bachelor of arts degree in Education and Sociology. Subsequently, she was employed by the Milwaukee Area Technical College as a Discussion Leader in the College's adult education program. As a Discussion Leader, she was a part-time member of the College's faculty. She enrolled in the University of Wisconsin, Milwaukee, as a candidate for a master of science degree in Educational Psychology--Counseling and Guidance, while continuing her employment as a Discussion Leader at the College. After being awarded the master of science degree, she began to participate in an Internship Program which involved course work at the University and acting as an intern guidance counselor at a high school. After completing the Internship Program, she was certified by the Wisconsin Department of Public Instruction whereupon she secured employment in another high school as a guidance counselor.

Held: (1) Under sec. 1.162-5(b)(3)(i), Income Tax Regs., "all teaching and related duties shall be considered to involve the same general type of work."

ORIGINAL

Petitioner-wife's education did not qualify her for a new trade or business. Petitioner-wife's education expenses are deductible. Sec. 162(a), I.R.C. 1954.

(2) Payments to petitioner-wife under the Internship Program are excludible from income as scholarships or fellowship grants. Sec. 117(a), I.R.C. 1954.

(3) Petitioner-wife was not a candidate for a degree at an educational institution while she participated in the Internship Program; her exclusions from income are not to exceed the limits provided by sec. 117(b)(2)(B), I.R.C. 1954.

Lawrence A. Trebon, for the petitioners.

Ellen T. Friberg, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

CHABOT, Judge: Respondent determined deficiencies in Federal individual income tax against petitioners for 1976 and 1977 in the amounts of $1,183.34 and $1,734.00, respectively.

After concessions by both sides the issues for decision[1] are as follows:

(1) Whether petitioners may deduct education expenses under section 162;[2]

(2) Whether petitioners may exclude amounts received, as scholarships or fellowship grants under section 117; and

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[1] The medical expense adjustment as to 1977 is derivative and depends on our resolution of the exclusion issues.

[2] Unless indicated otherwise, all section and chapter references are to sections and chapters of the Internal Revenue Code of 1954 as in effect for the years in issue.

(3) If issue (2) is answered in the affirmative, then whether petitioners' exclusions are limited by section 117(b)(2).

FINDINGS OF FACT

Some of the facts have been stipulated; the stipulations and the stipulated exhibits are incorporated herein by this reference.

When the petition was filed in the instant case, petitioners Gerald Schwerm and Joyce J. Schwerm (hereinafter sometimes referred to as "Joyce"), husband and wife, resided in Milwaukee, Wisconsin.

Discussion Leader

In June 1955, Joyce was graduated from Milwaukee State Teachers College with a degree of bachelor of arts in Education and Sociology. From September 1974 through June 1976, Joyce was employed as a Discussion Leader in the Milwaukee Area Technical College (hereinafter sometimes referred to as "MATC"), Family Living Education Program (hereinafter sometimes referred to as "the Family Program").

The Family Program is an adult education program which relies on group interaction. It is an outreach program, operating through discussion groups which meet at various locations in the community, including transition centers, community centers, day care centers, social agencies, halfway houses, park buildings, store fronts, hospitals, libraries, churches, prisons, schools, and homes. Trained discussion leaders are provided for groups of ten or more people.

Discussion topics are chosen in response to the needs of a group and according to the needs of the community at a given time. The topics have included parent-child relationships, family relationships, communication problems, self-awareness, assertiveness training, parent effectiveness training, coping with stress, and coping with problems of retirement.

A Discussion Leader serves as a facilitator for a number of discussion groups. A Discussion Leader begins a discussion group session by supplying participants with background information concerning the discussion topic, through the use of resource materials, which may include textbooks, films, filmstrips, slides, overhead projectors, records, newsprints, and handout materials.

In planning for a discussion group, Joyce and other Discussion Leaders either would meet with the Family Program's coordinator to establish the format, or would establish the format independently and then indicate to the coordinator the information and materials which are to be used. If necessary, the Family Program provides the required materials to the Discussion Leader. Joyce selected the materials for use in her discussion groups.

After supplying the background information to the participants, the Discussion Leader uses techniques to help participants feel comfortable with the group and with each other, and helps them to come forth with their concerns and interests. The Discussion Leader is to guide the discussions so that all the participants have the opportunity to participate and learn what they have come to learn. The Discussion Leader is to prevent any one of the participants from controlling the discussion.

Each discussion group lasts for a minimum of 2 hours. Most discussion groups meet on a weekly basis from September through May. Participants in a discussion group neither pay tuition nor receive grades. However, they do register as students at MATC. The subject matter of a discussion group is not offered for credit to any MATC student.

Discussion Leaders are paid on the basis of the number of discussion groups conducted and not on a salary basis. Discussion Leaders are not eligible for tenure, fringe benefits, or any other contract benefits at MATC. Each Discussion Leader conducts between 4 and 10 group sessions a week. Joyce conducted about eight discussion group sessions per week and received as compensation from MATC about $25 per session.

MATC regularly maintains a staff of 20 Discussion Leaders. A Discussion Leader is a part-time employee regardless of the length of employment. There is no minimum educational requirement for a position as a MATC Discussion Leader other than a high school diploma. A Discussion Leader need not have any prior teaching experience. However, a Discussion Leader must be able to establish rapport with a variety of individuals and be creative in the use of resource materials. A Discussion Leader should be able to work in the community (as opposed to working in a structured kind of setting) and it is preferred that a Discussion Leader have a combination of group work and teaching experiences. All staff at MATC, including Discussion Leaders, are required to participate in ongoing in-service programs.

Master of Science Degree

The Department of Educational Psychology (hereinafter sometimes referred to as "the Department") at the University of Wisconsin, Milwaukee (hereinafter sometimes referred to as "the University"), maintains a graduate Counseling and Guidance program (hereinafter sometimes referred to as "the Graduate Program"), for students to pursue a course of study to receive a master of science degree in Educational Psychology. The purpose of the Graduate Program is to prepare graduate students to become school counselors.

From 1974 through May 1977, Douglas J. Mickelson (hereinafter sometimes referred to as "Mickelson"), then an associate professor of the Department, was responsible for administering the Graduate Program. From 1974 through 1976, Mickelson was the counseling area chairman in the Department. His responsibilities included reviewing applications to the

Graduate Program, admitting students to the Graduate Program, scheduling the sequencing of the Graduate Program, administering the internship program, and recommending to the Wisconsin Department of Public Instruction (hereinafter sometimes referred to as "the WDPI") at the conclusion of an internship program (described, infra) whether the student successfully completed certification requirements.

In September 1974, Joyce entered the Graduate Program for a master of science degree in Educational Psychology--Counseling and Guidance. She did so because she believed she should improve her skills and background so as to become a better Discussion Leader.

The WDPI, the governing body for Wisconsin's public primary and secondary schools, establishes the requirements for State certification as a school counselor. In order to receive a school counselor-provisional level certification, an individual must obtain a master of science degree in counseling and guidance and either (1) be certified as a school teacher and have taught for 2 years in the area in which the individual is certified as a school teacher or (2) complete a 1 year school counseling internship program (hereinafter sometimes referred to as "the Internship Program").

Joyce is not certified as a school teacher in Wisconsin.

Completion of the requirements for a master of science degree in counseling and guidance is a prerequisite to entering the Internship Program. On August 14, 1976, Joyce received a master of science degree in Educational Psychology.

The Internship Program

The Internship Program has been in existence since 1968; it is still called an experimental program. The Internship Program was designed to supplant the 2 year teaching experience requirement for certification as a school counselor. The Internship Program was established to attract qualified school counselor candidates who would not normally enter the field of education and are not interested in being classroom teachers.

The purpose of the Internship Program is to acquaint the intern with the life and work of a school and to provide to the intern the educational and on-the-job experience necessary to become a certified school counselor.

The Internship Program is conducted by the WDPI together with cooperating universities and schools. The WDPI approved the school counselor internship alternative in the counselor education programs of the following five Wisconsin universities (effective with the start of the 1968-1969 school year): (1) the University; (2) University of Wisconsin, Madison; (3) University of Wisconsin, Oshkosh; (4) University of Wisconsin, Platteville; and (5) University of Wisconsin-Stout, Menomonie. Completion of the Internship Program is not a requirement for the master of science degree in Educational Psychology at the University (however, it is a requirement for the degree at the University of Wisconsin, Madison).

The Internship Program is an extension of the Graduate Program, with the intern remaining a student for credit at the University during the internship; the Internship Program is administered by the Department.

As part of the admissions process to the Graduate Program, the applicant is interviewed; one of the areas discussed at the interview is the applicant's future employment plans. If an applicant indicates an interest in becoming a school counselor but does not have the requisite 2 years of teaching experience and the proper undergraduate teaching preparation, then the Graduate Program interviewer indicates that the Internship Program (which comes after the Graduate Program) is a means of accomplishing the applicant's desired goal.

The Department actively solicits schools to participate in the Internship Program. Some of the schools participating in the Internship Program take one intern each year. Other schools are not interested in participating in the Internship Program primarily because of budgetary constraints, combined with the limitations on the participating schools' control over the duties and responsibilities of the interns. Also, some superintendents and principals strongly believe that the only way an individual could work as a school counselor is to have been certified as a school teacher and to have taught 2 years in the teacher's certification subject area.

After a school indicates an interest in participating in the Internship Program by "hosting" an intern, representatives of the Department meet with representatives of the school district and explain that there are conditions that must be satisfied. In particular, it is explained that the intern must not supplant a full-time staff member; the intern is to supplement the school district's then-current counseling staff; the intern must be supported by funds in the local district (no funds from Federal categorical grants are to be be used); and there must be on-site supervision.

Under the Internship Program, the intern is required to have a "broad range sort of experience"; for example, it is unacceptable for an intern to be assigned to work with a counselor who is working only on college admissions, even though college admissions assistance is what the host school needs.

The intern signs a contract with the school district. However, the school district does not have free control over the duties and responsibilities of the intern. In addition, the intern has no obligation for future employment with the school in which he or she serves as an intern, after the intern successfully completes the Internship Program.

If Mickelson determines that a school would meet the requirements of the Internship Program, then he writes a letter to the WDPI requesting approval for the school to have an intern. The WDPI either grants approval or, in some cases, requests additional information.

Often the school district indicates that it would like to interview several intern candidates. The Department then chooses several interns that would be most likely to fit in with what the school district has indicated as its interest.

Under the Internship Program, the Department is responsible for providing "off-site supervision". This consists of visiting each host school at least once a semester, and meeting with each intern and that intern's on-site supervisors in order to monitor the intern's activities so as to ensure that (1) the intern receives a variety of educational experiences and (2) on-site supervision is being provided.

The internship consists of work experience as an intern school counselor at a host school for 1 school year, and participation in regular classes at the cooperating university and in seminars at the cooperating university or in the host school district.

When the interns return to the University every 2 weeks for classes or seminars, the Department has them meet in supervised sessions to discuss the different types of activity that they participate in. Occasionally, such a session would turn into a support group, where an intern having difficulties at a school could discuss the situation.

The WDPI's guideline for payments to an intern is that "[t]he minimum salary to be paid to an intern is approximately $5,200.00 and preferably at least 75% to 80% of the equivalent salary step in the [school] district for someone with comparable training and experience." During 1976 and 1977, the University required that interns be paid and recommended that the amount equal about 60 percent of that paid to beginning guidance counselors.

Apart from the Internship Program, school districts are not permitted to hire noncertified school counselors.

When the internship is completed, the intern is eligible for school counselor-provisional level certification from the State of Wisconsin. In order to be eligible for professional level certification, the individual must complete 2 years of work as an assigned school counselor, and complete an additional nine credits of graduate work.

Joyce's Internship

The University was the cooperating university and it selected Hamilton High School (hereinafter sometimes referred to as "Hamilton") as the site of Joyce's internship. The WDPI approved Joyce's internship at Hamilton and confirmed that Richard Granum (hereinafter sometimes referred to as "Granum") would be Joyce's supervising counselor. Joyce participated in the Internship Program at Hamilton from September 1976 through June 1977.

When an intern begins the Internship Program at Hamilton, Hamilton assumes that the intern has the basic skills in counseling. At Hamilton, an intern is first oriented to the school system; the amount of time for orientation varies with the intern. At first, the intern is basically an observer. Hamilton recognizes its obligation to comply with the requirements of the Internship Program and after the orientation period it provides the intern with a full range of experiences, including individual and group counseling, educational training, and work training. Also, depending on his or her maturity, an intern would deal with personal and social problems, including early pregnancies and drug and alcohol abuse and treatment.

All of the activities that an intern performs at Hamilton, including establishing programs, must be checked with the intern's direct supervisor. A certified school counselor does not receive the extensive supervision that an intern receives and is not subject to the same restrictions as an intern.

Hamilton received the necessary funding to pay an intern from the cooperating university that the intern was from. While Joyce participated in the Internship Program, Hamilton received the necessary funding to pay Joyce from the University.

Hamilton was required to give reports as to each intern's progress, to the president of the cooperating university that the intern was from. At Hamilton, an intern is "treated" as a member of the faculty although he or she is not a member of the faculty. Joyce was allowed to participate in Hamilton's medical insurance program. However, she was not covered by the master contract, she was not covered by the union, and she did not receive tenure.

During her internship, Joyce was required to be at Hamilton from 8:00 a.m. to 2:30 p.m., Monday through Friday, except on alternate Fridays when she attended a three-hour class beginning at 1:00 p.m. at the University. She was also allowed time off to attend some seminars and meetings. Granum provided daily direct supervision to Joyce. She participated in the full range of counselling activities at Hamilton. Joyce was required to maintain a B average in order to successfully complete the Internship Program. Her grade was determined by the University, with input from Granum. Joyce received 12 credits at the College for completing the internship, including the biweekly classes.

There was no employment obligation after Joyce finished her internship either on the part of Joyce or of Hamilton School District.

Each school year from 1974-1975 through 1980-1981, there were four certified school counselors working at Hamilton. Hamilton has participated in the Internship Program since 1975. During the 1975-1976 school year, Hamilton had two interns.

Joyce was the only intern at Hamilton during the 1976-1977 school year. From the 1977-1978 school year through the 1980-1981 school year, Hamilton has had only one intern.

Hamilton's guidance staff could have performed their duties without Joyce.

The University certified to the WDPI that Joyce had successfully completed the Internship Program; the WDPI certified her as a "school counselor-provisional level".

Joyce received $6,890.05 from Hamilton School District during her internship; $2,223.33 was received in 1976 and $4,666.72 was received in 1977. The amounts Joyce received were not based in any way on her individual financial need.

In 1976, Hamilton School District withheld from the amounts paid to Joyce, $254.00 in Federal income tax, $130.05 in Federal Insurance Contributions Act tax, and $75.70 in State or local tax. In 1977, Hamilton School District withheld for these same items $550.40, $272.98, and $163.20, respectively.

Joyce spent $1,915.82 in 1976 for education expenses as set forth in Table 1:

Table 1

Preinternship Education Expenses	$1,157.50
Internship Program Tuition	368.90
Wisconsin Personal Guidance Ass'n (training conference)	23.00
National Training & Development Service Toronto, Canada (training conf.)	366.42
	$1,915.82

Joyce spent $448.10 for education expenses in 1977, including $368.90 for Internship Program tuition and $79.20 for transportation.

Joyce has been employed by Shorewood High School (hereinafter sometimes referred to as "Shorewood") as a High School Career Experience Coordinator since 1977. At Shorewood, Joyce helps students to think through and plan their future career goals. She reports directly to the principal. Shorewood expects Joyce to have the organizational skills to initiate and maintain her responsibilities, and to perform her responsibilities without direct supervision. Joyce's responsibilities include the following: (1) conducting seminars and discussion groups to introduce the world of work to the students; (2) assisting students to develop and understand career interests; (3) referring students to specific career interests and to jobs; (4) maintaining vacancy listings for jobs of various kinds; (5) soliciting employers to establish career placement opportunities; and (6) making on-the-job visits to evaluate both the students and the employment.

* * * * * * * *

As a Discussion Leader at MATC, Joyce's trade or business consisted of teaching and related duties.

As a High School Career Experience Coordinator at Shorewood, Joyce's trade or business consists of teaching and related duties.

The nature of Joyce's duties and responsibilities as a Discussion Leader, an intern, and a High School Career Experience Coordinator are very similar; all three positions involve the same general type of work.

The purpose of the Internship Program was to provide an educational set of experiences for the intern. The Internship Program was of more benefit to Joyce than to Hamilton.

OPINION

I. Education Expenses

Personal expenses are not deductible, unless the contrary is "expressly provided" in chapter 1 (sec. 262[3]). Ordinarily, education expenses are regarded as personal. See, e.g., Welch v. Helvering, 290 U.S. 111, 115-116 (1933). However, section

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[3] SEC. 262. PERSONAL, LIVING, AND FAMILY EXPENSES.
Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses.

162(a)[4]--which is in chapter 1--expressly provides for the deduction of all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. As section 162(a) has been interpreted, education expenses may constitute deductible trade or business expenses if the education for which the expenses are made (1) maintains or improves the skills required in the taxpayer's employment or other trade or business, or (2) meets the express requirements of the taxpayer's employer (or of applicable law or regulations) imposed as a condition for the taxpayer to retain an established employment relationship. See, e.g., section 1.162-5(a), Income Tax Regs.

Even though education falls within one or both of the above categories, the expenses therefor are nevertheless nondeductible if the education either enables the taxpayer to meet the minimum educational requirements for qualification in his or her employment or other trade or business (which is not the instant case), or qualifies the taxpayer for a new trade or business. Garwood v. Commissioner, 62 T.C. 699 (1974); section 1.162-5(b), Income Tax Regs.

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[4] Section 162(a) provides in relevant part as follows:

SEC. 162. TRADE OR BUSINESS EXPENSES.
(a) In General.--There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *

Under section 1.162-5(b)(3), Income Tax Regs.,[5] if a taxpayer is pursuing a course of educational study which will qualify him or her for a new trade or business, the expenditures are not deductible even though the studies are required by the employer, even though the taxpayer does not intend to enter the new field of endeavor (Bodley v. Commissioner, 56 T.C. 1357, 1360 (1971)), and even though the taxpayer's duties are not significantly different after the education from what they had been before the education (Robinson v. Commissioner, 78 T.C. 550, 556-558 (1982)).[6]

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[5] Section 1.162-5(b), Income Tax Regs., provides in relevant part as follows:

> Sec. 1.162-5. Expenses for education.
>
> * * *
>
> (b) Nondeductible educational expenditures.--
>
> * * *
>
> (3) Qualification for new trade or business. (i) The second category of nondeductible educational expenses within the scope of subparagraph (1) of this paragraph are expenditures made by an individual for education which is part of a program of study being pursued by him which will lead to qualifying him in a new trade or business. In the case of an employee, a change of duties does not constitute a new trade or business if the new duties involve the same general type of work as is involved in the individual's present employment. For this purpose, all teaching and related duties shall be considered to involve the same general type of work. The following are examples of changes in duties which do not constitute new trades or businesses:
>
> (a) Elementary to secondary school classroom teacher.
>
> (b) Classroom teacher in one subject (such as mathematics) to classroom teacher in another subject (such as science).
>
> (c) Classroom teacher to guidance counselor.
>
> (d) Classroom teacher to principal.
>
> * * *

Both sides agree that the education Joyce received in 1976 and 1977, from the Graduate Program and the Internship Program (1) maintained and improved skills required by Joyce in her employment as a Discussion Leader at MATC and (2) was not necessary to meet the minimum requirements for her position as a Discussion Leader at MATC.

Respondent maintains that the Graduate Program and the Internship Program were parts of a program of study pursued by Joyce which would lead to qualifying her in a new trade or business. On brief, respondent amplifies his position as follows:

> The respondent's position is that the examples [of changes in duties which do not constitute new trades or businesses] in Treasury Regulation §1.162-5(b)(3)(i) which clearly involve minimal changes in duties and responsibilities do not apply to the facts in this case. The respondent contends that the significant changes in duties and responsibilities which accompanied the change from leading part-time, non-credit discussion groups as a community service, to becoming a high school guidance counselor are more in the nature of a change from a paraprofessional to a professional position. See Diaz v. Commissioner, 70 T.C. 1067, 1075 (1978), aff'd mem. 607 F.2d 995 (2d Cir. 1979). That significant shift is not within

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[6] The education expense regulation here relevant was promulgated in 1967. It replaced a regulation that had been promulgated in 1958. The "old" (1958) regulation embodied a subjective "primary purpose" test. The "new" (1967) regulation replaces this with an objective test, in particular the qualification-for-new-trade-or-business test, embodied in section 1.162-5(b)(3) (n.5, supra). Taubman v. Commissioner, 60 T.C. 814, 817-819 (1973).

> the same category as those changes in duties set forth in the Treasury Regulations which do involve the same general type of work.

Petitioners maintain that Joyce's education expenses in 1976 and 1977 are deductible under section 162(a) because her positions as a Discussion Leader, intern school counselor, and High School Career Experience Coordinator all involve the same general type of work, i.e. teaching, counseling, and guidance. Petitioners argue that (1) the master of science degree in Educational Psychology that Joyce received from the University did not qualify her for anything other than the Internship Program and (2) the Internship Program qualified Joyce for certification as a provisional school counselor in Wisconsin's public school system. Petitioners assert that the position of school counselor does not constitute a new trade or business for Joyce. Thus, petitioners conclude, the education expenses for Joyce's master of science degree and for the Internship Program are deductible since the expenses satisfy the requirements of section 1.162-5(a), Income Tax Regs., and are not rendered nondeductible by section 1.162-5(b), Income Tax Regs.

We agree with petitioners.

This Court has adopted a "commonsense approach" in determining whether an education expenditure qualifies a taxpayer for a new trade or business. Reisinger v. Commissioner, 71 T.C. 568, 574 (1979); Davis v. Commissioner, 65 T.C. 1014, 1019 (1976); Glenn v. Commissioner, 62 T.C. 270, 275 (1974). "If the education qualifies the taxpayer to perform significantly different tasks and activities than he or she could perform prior to the education, then the education qualifies him or her for a new trade or business." Browne v. Commissioner, 73 T.C. 723, 726 (1980); Diaz v. Commissioner, 70 T.C. 1067, 1074 (1978), affd. without published opinion 607 F.2d 995 (CA2 1979); Glenn v. Commissioner, 62 T.C. at 275.

Whatever may be the standards for "new trade or business" in different types of endeavors, respondent's regulations provide special rules applicable to the instant case; viz, "all teaching and related duties shall be considered to involve the same general type of work. The following are examples of changes in duties which do not constitute new trades or businesses: * * * (c) Classroom teacher to guidance counselor." Section 1.162-5(b)(3)(i), Income Tax Regs.[7]

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[7] Licensing and certification requirements often are indicators of separate trades or businesses. E.g., Robinson v. Commissioner, 78 T.C. 550 (1982) (a licensed registered nurse different trade or business from a licensed practical nurse); Johnson v. Commissioner, 77 T.C. 876 (1981) (a licensed real estate broker different trade or business from a licensed real estate agent); Reisinger v. Commissioner, 71 T.C. 568 (1979) (a certified physician's assistant different trade or business from a licensed practical nurse); Sharon v. Commissioner, 66 T.C. 515 (1976) affd. 591 F.2d 1273 (CA9 1978) (a licensed California attorney different trade or business from a licensed New York attorney); Glenn v. Commissioner, 62 T.C. 270 (1974) (a licensed certified public accountant different trade or business from a licensed public accountant). However, respondent's regulations lead to different results for school people in many settings. E.g., Toner v. Commissioner, 623 F.2d 315 (CA3 1980), revg. 71 T.C. 772 (1979) (a public school elementary teacher same trade or business as a parochial school elementary teacher); Laurano v. Commissioner, 69 T.C. 723 (1970) (a certified teacher in Toronto,
(footnote continued)

Joyce was employed as a Discussion Leader by the Milwaukee Area Technical College. As a Discussion Leader, she was a part-time member of the faculty of MATC.

The Family Program is an adult education program of MATC. Joyce's responsibilities and activities as a Discussion Leader, set forth in detail in our findings of fact, make it plain (and we have so found) that her trade or business can fairly be subsumed within the "teaching and related duties" rubric of respondent's regulations.

Joyce's school counseling work at Shorewood consists of teaching and related duties.

We conclude that Joyce's work at MATC and her work at Shorewood are more alike than the work of a classroom teacher and a guidance counselor. Accordingly, we conclude that Joyce's education in the Graduate Program and the Internship Program did not qualify her for a new trade or business. In light of the parties' agreements with regard to the other requirements of paragraphs (a) and (b) of section 1.162-5, Income Tax Regs., we

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(footnote continued from previous page)
Canada, same trade or business as a certified teacher in New Jersey). Since neither side in the instant case contends that this preferential treatment causes the regulations to be invalid in whole or in part, we have no occasion to consider the matter. We take the regulations as we find them. If respondent does not like the result, then he may try to persuade the Treasury Department to change the regulations. See, e.g., Woods Investment Co. v. Commissioner, 85 T.C. 274, 282 (1985).

conclude that petitioners are entitled to trade or business expense deductions on account of Joyce's education expenditures for these two programs.

Respondent contends that Joyce's role as a Discussion Leader at MATC was that of a paraprofessional, that Joyce's role at Shorewood is that of a professional, and that our opinion in *Diaz v. Commissioner*, 70 T.C. at 1075, leads to the conclusion that Joyce became qualified for a new trade or business. We disagree.

In *Diaz*, the taxpayer was employed as an educational assistant, and then an educational associate, in the New York City public school system. Her job was to assist the regular classroom teacher or teachers in the performance of their duties. We pointed out that the taxpayer "was not authorized to assume the complete control and responsibility for the classroom and the instructional activities within it. Moreover, she was not given the primary responsibility for the planning preparation of the instructional activities in the classroom. Accordingly, [we concluded that the taxpayer] did not perform those duties we find essential to the teaching function * * *. Moreover, we do not believe these examples [in sec. 1.162-5(b)(3)(i), Income Tax Regs.] suggest that a shift from paraprofessional to classroom teacher, with the significant changes in responsibility and control that accompany such a shift, is within the same category as those changes in duties that do involve the same general type of work." 70 T.C. at 1075. In contrast, in the instant case, Joyce had the same sort of responsibility and control in her Discussion Leader employment as in her employment as a school counselor. Joyce's work as a Discussion Leader was not an apprenticeship for her work as a school counselor. *Diaz* does not present an appropriate analogy for the instant case.

We hold for petitioners on this issue.

II. Internship Program Stipend

Respondent maintains that the amounts Joyce received from Hamilton during the Internship Program represent compensation for services performed and are not properly excludable from income. Alternatively, respondent contends that if these amounts are scholarships or fellowship grants under section 117, then the excludable amount is limited under section 117(b)(2), since Joyce was not a candidate for a degree. Petitioners maintain that the amounts received are scholarships or fellowship grants, and that Joyce was a candidate for a degree and so the entire amount is excludable.

We agree in part with each side; we agree with petitioners that the amounts are scholarships or fellowship grants, and we agree with respondent's alternative position that the exclusion is not to exceed the limits applicable to taxpayers who are not candidates for degrees.

A. Scholarship or Fellowship Grant

Section 117(a)(1)[8] provides generally that scholarships and fellowship grants are excludable from gross income.

Section 1.117-4, Income Tax Regs., provides that amounts paid to "an individual to enable him to pursue studies or research are considered to be amounts received as a scholarship or fellowship grant for the purpose of section 117 if the primary purpose of the studies or research is to further the education and training of the recipient in his individual capacity". Section 1.117-4, Income Tax Regs., also provides that "[n]either the fact that the recipient is required to furnish reports of his progress to the grantor, nor the fact that the results of his studies or research may be of some incidental benefit to the grantor shall, of itself, be considered to destroy the essential character of such amount as a scholarship or fellowship grant."

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[8] SEC. 117. SCHOLARSHIPS AND FELLOWSHIP GRANTS.

(a) General Rule.--In the case of an individual, gross income does not include--

(1) any amount received--

(A) as a scholarship at an educational institution (as defined in section 151(e)(4)), or

(B) as a fellowship grant,

including the value of contributed services and accommodations; * * *

[For taxable years beginning after December 31, 1976, subparagraph (A) reads as follows: "(A) as a scholarship at an educational organization described in section 170(b)(1)(A)(ii)". This change in terminology (resulting from secs. 1901(b)(8)(A) and 1901(d) of the Tax Reform Act of 1976, Pub. L. 94-455, 90 Stat. 1520, 1794, 1803) applies to the second of the years before the Court in the instant case but does not affect the analysis herein.]

However, the terms "scholarship" and "fellowship grant" do not include any amount which "represents either compensation for past, present, or future employment services or represents payment for services which are subject to the direction or supervision of the grantor." Section 1.117-4(c)(1), Income Tax Regs.

In Bingler v. Johnson, 394 U.S. 741, 751 (1969), the Supreme Court sustained the validity of these regulations stating that:

> [T]he definitions supplied by the Regulation clearly are prima facie proper, comporting as they do with the ordinary understanding of "scholarships" and "fellowships" as relatively disinterested, "no strings" educational grants, with no requirement of any substantial quid pro quo from the recipients.

Thus, under these regulations the distinction between compensation for services, and a scholarship or fellowship grant turns on whether the recipient was paid to work or paid to study. Zolnay v. Commissioner, 49 T.C. 389, 396 (1968). Determination of the primary purpose of such payments must necessarily "turn upon its own particular facts and circumstances." Steiman v. Commissioner, 56 T.C. 1350, 1355 (1971); Zolnay v. Commissioner, 49 T.C. at 395.

Petitioners have the burden of proving that the amounts received were scholarships or fellowship grants. Olick v. Commissioner, 73 T.C. 479, 486 (1979); Rule 142(a).[9]

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[9] Unless indicated otherwise, all rule references are to the Tax Court Rules of Practice & Procedure.

In making the determination, we acknowledge that we are dealing with another one of those areas of our tax laws where precise line-drawing is often difficult. *Olick v. Commissioner*, 73 T.C. at 486; *Zolnay v. Commissioner*, *supra*. Based on the record as a whole, we conclude that the primary purpose of the amounts paid by Hamilton to Joyce was to enable her to study and not to compensate her for services rendered to Hamilton. Hamilton did not require a substantial quid pro quo from Joyce in return for the amounts she received. We conclude that the amounts received by Joyce constituted a scholarship or fellowship grant within the meaning of section 117(a)(1). Our decision rests on several factors, as follows:

> (1) Under the Internship Program, the host school is forbidden to use the intern to supplant a full-time staff member. Hamilton's staff could have performed their guidance duties without Joyce.
>
> (2) The host school is required to provide supervision.
>
> (3) Although the host school may be allowed to interview several intern candidates, if it chooses to participate in the Internship Program it must select the intern from among those provided by the WDPI.
>
> (4) The host school is required to give the intern a wide range of experience, regardless of the work needs of the host school.

(5) Apart from the Internship Program, school districts are not permitted to hire noncertified school counselors.

(6) Neither the host school nor the intern is obligated to the other with respect to employment after the intern completes the Internship Program.

(7) Although Hamilton School District paid Joyce, it did so with funds provided to it by the University for the purpose of paying Joyce.

Respondent contends that petitioners appear to be taking inconsistent positions. The asserted inconsistency is that the education expense deduction must be based on engaging in a trade or business at the time of the expense, while the section 117 grant requires that the taxpayer not be compensated for services.

Although currently unemployed, a taxpayer can still be engaged in a trade or business if he or she was previously involved in and actively seeks return to that trade or business. E.g., Furner v. Commissioner, 393 F.2d 292, 295 (CA7 1968), revg. 47 T.C. 165 (1966); Ford v. Commissioner, 56 T.C. 1300 (1971), affd. 487 F.2d 1025 (CA9 1973). See Reisinger v. Commissioner, 71 T.C. at 572; Haft v. Commissioner, 40 T.C. 2, 6 (1963). In the instant case, Joyce continued working as a Discussion Leader while attending classes at the University. However, she had to discontinue working at MATC during the Internship Program, because the Internship Program required a full-time commitment. After successfully completing the Internship Program and receiving her certification, Joyce accepted a position as a High School Career Experience Coordinator with Shorewood. Joyce did not abandon her trade or business while she participated in the Internship Program.

We hold for petitioners on this issue.

B. Candidacy for a Degree

Section 117(b)(2)(B)[10] limits the amount that may be excluded in the case of an individual who is not a candidate for a degree. Joyce received her master of science degree in Educational Psychology from the University in August 1976; she began the Internship Program in September 1976.

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[10] SEC. 117. SCHOLARSHIPS AND FELLOWSHIP GRANTS.

* * *

(b) Limitations.--

* * *

> (2) Individuals who are not candidates for degrees.--In the case of an individual who is not a candidate for a degree at an educational institution (as defined in section 151(e)(4)), subsection (a) shall apply * * * only within the limitations provided in subparagraph (B).
>
> * * *
>
> (B) Extent of exclusion.--The amount of the scholarship or fellowship grant excluded under subsection (a)(1) in any taxable year shall be limited to an amount equal to $300 times the number of months for which the recipient received amounts under the scholarship or fellowship grant during such taxable year, except that no exclusion shall be allowed under subsection (a) after the recipient has been entitled to exclude under this section for a period of 36 months (whether or not consecutive) amounts received as a scholarship or fellowship grant while not a candidate for a degree at an educational institution (as defined in section 151(e)(4)).

[See bracketed material at end of n.8, supra.]

It is true that Joyce was a student at the University during her participation in the Internship Program, but nothing in the record in the instant case indicates that she was a candidate for a degree at any time after she was awarded the master of science degree in August 1976.

We conclude that the limitations of section 117(b)(2)(B) apply in determining the amounts of Joyce's scholarship or fellowship grant exclusions.

Petitioners state that the WDPI's certificate to Joyce "is the equivalent of a degree." The certificate referred to is the one certifying Joyce as a "school counselor-provisional level". Petitioners rely on Rev. Rul. 58-338, 1958-2 C. B. 54, and section 1.117-3(e), Income Tax Regs.

Firstly, the statute (n.10, *supra*) refers to "a degree at an educational institution". The certificate in question is a license to engage in a particular employment and is issued by a regulatory licensing agency. We do not regard the certificate as equivalent to a degree.

Secondly, aside from the fact that respondent's rulings are not binding on the Court (e.g., *Warsaw Photographic Associates v. Commissioner*, 84 T.C. 21, 39 n.22 (1985); *Burck v. Commissioner*, 63 T.C. 556, 561-562 (1975), affd. 533 F.2d 768 (CA2 1976)), Rev. Rul. 58-338 does not help petitioners. The ruling merely states respondent's position that an accredited school of nursing's certificate qualifies as an educational institution's degree for purposes of section 117. The critical element of distinction is that the accredited school of nursing referred to in the ruling is an educational institution, while the instant record shows that the WDPI's action in issuing the certificate is essentially an action of a regulatory and licensing body.

Thirdly, the cited regulation also merely makes the point that a diploma or certificate of an educational institution may be equivalent to a degree. Once again, petitioners' argument falls because of a failure to show that Joyce's certificate was issued by an educational institution and that the certificate was not essentially a license.

We hold for respondent on this issue.

Decision will be entered
under Rule 155.

Ju 11.7/2:1986-17

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T. C. Memo. 1986-17

UNITED STATES TAX COURT

DONALD G. CORLEY, MARY E. CORLEY, BARRY J. GLICK, DEBORAH A. GLICK, ALVIN [illegible] GLICK, BARBARA M. GLICK, CARLTON L. GLICK, DENISE L. GLICK AND RANDAL L. GLICK, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 4108-83. Filed January 13, 1986.

Held: A Michigan land contract executed by the limited partnership in which petitioners were partners had an ascertainable fair market value. Therefore, under the installment sale provisions, gain on the sale must be reported as payments are receiv

Michael D. Gingras, for the petitioners.

Jacqueline M. Hotz, for the respondent.

ORIGINAL

MEMORANDUM OPINION

WHITAKER, *Judge*: Respondent determined the following deficiencies in petitioners' Federal income taxes for the years 1978 through 1980:

Petitioner(s)	1978	1979	1980
Donald G. and Mary E. Corley	$3,385.00	$2,350.00	-
Barry J. and Deborah A. Glick	2,256.00	513.00	$827.00
Alvin L. and Barbara M. Glick	4,535.00	100.00	-
Carlton L. and Denise L. Glick	3,187.00	549.00	505.00
Randal L. Glick	-	-	115.00

After concessions by the parties, the issue for our decision is whether a land contract, without an accompanying negotiable instrument, had an ascertainable value for purposes of reporting gain from an installment sale pursuant to section 453.[1]

The parties have submitted this case with the facts fully stipulated. The stipulation of facts and accompanying joint exhibits are incorporated herein by this reference.

Petitioners were residents of Jackson, Michigan when the petition herein was filed.

On October 16, 1974, Argyle Acres, Ltd. (Argyle), a Michigan limited partnership, was formed consisting of one general partner, petitioner Barry J. Glick, and four limited partners,

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[1] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue, and all rule references are to the Tax Court Rules of Practice and Procedure.

Hirschie Schaffner and petitioners Donald G. Corley, Alvin L. Glick, and Carlton L. Glick. Under the terms of the partnership agreement, the general partner and each of the limited partners shared the gain or assumed the loss of the partnership equally. Argyle used the cash method of accounting when reporting rental income and expenses.

Argyle purchased a shopping center in Jackson, Michigan. A mortgage was secured from IDS Mortgage Corporation, which was subsequently assigned to Northwestern National Life Insurance Company (Northwestern).

On November 10, 1978, Argyle sold the shopping center for $1,239,000. Of this amount, $10,000 was paid as earnest money and $185,000 was paid upon execution of the land contract. An escrow agreement was simultaneously executed to provide for payment of the $1,044,000 balance. This balance consisted of $710,793.49 due on the Northwestern mortgage and $333,206.51 due Argyle. The taxable gain on the sale was $419,504.

Pursuant to the land contract and escrow agreement, the purchasers were required to make payments into escrow of $10,000 per month for the first 10 years. The amount of $7,493.75 from these monthly payments was applied to the principal and interest accruing on the outstanding mortgage held by Northwestern.[2] The balance, $2,506.25, was paid directly to the five partners of

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[2] The purchasers agreed to all of the terms and conditions of the existing mortgage and Argyle agreed to use its best efforts to provide, at closing, Northwestern's written consent to the sale. The record is silent as to whether this written consent was provided.

Argyle in equal 20 percent shares. At the end of 10 years, the purchasers were required to make a balloon payment to Argyle equal to the balance due the partnership ($333,206.51 plus interest accruing thereon at 9-3/4 percent) less the portion of the monthly payments paid to the partners over the prior 10 years. Since Argyle's share of the purchasers' monthly payments was less than the amount of interest accruing, the balance due would exceed the initial $333,206.51 owed. After the balloon payment, the purchasers' monthly payments were reduced to the $7,493.75 paid to Northwestern.

Upon default by the purchasers, Argyle was entitled to: (1) declare the land contract forfeited and void; (2) retain all amounts paid under the land contract and all improvements, additions, and accretions to the shopping center; and (3) obtain a deficiency judgment against petitioners not to exceed $150,000. Argyle reserved the right to convey its interest during the period of the land contract and to encumber the property by mortgages not to exceed the $333,206.51 balance owed the partnership. After the balloon payment, Argyle's right to encumber the property ceased.

Under the land contract, the purchasers were required to make $50,000 of improvements within the first 12 months. They were also required to pay all taxes and assessments and to maintain insurance on the building. The purchasers took possession of the shopping center subject to the existing tenants' rights and Argyle assigned these tenants' contracts to the purchasers.

The escrow agreement further provided that an executed warranty deed would be held by the escrow agent until all terms of the land contract were fulfilled.

Under an agreement dated March 1, 1979, petitioner Alvin L. Glick transferred his entire interest in Argyle to a trust established for the benefit of his son, petitioner Randal L. Glick.

During the years in issue, Argyle received the following payments:[3]

1978	1979	1980
$219,072.00	$16,190.00	$17,974.00

None of the petitioners reported any gain from the sale of the shopping center on their Federal income tax returns during the years in issue. The deficiency notices issued by respondent challenge this omission on the basis that gain from the sale of the shopping center should be reported under the normal installment method provided in section 1.453-5(a)[4], Income Tax Regs.

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[3] Although the stipulation is not explicit, these "payments" include only that portion of payments representing principal.

[4] Under this method, respondent asserts that the gross profit percentage to use in determining the amount of income to be reported is 33.9 percent. Petitioners have not contested this percentage and are deemed to have conceded it if the normal installment method of reporting is found appropriate. Implicit in this concession is the fact that the land contract, if its value is ascertainable, was worth the unpaid balance on the date of the transaction, although an argument might be made that it was worth less than the unpaid balance.

Petitioners' contend that gain from the sale should be reported under the cost recovery method pursuant to section 1.453-6(a)(2),Income Tax Regs.

The parties agree that Argyle's sale of the shopping center qualifies for reporting under the installment method pursuant to section 453.[5] Subsections 453(a) and (b) and section 1.453-5(a), Income Tax Regs., provide the general rule that, on a qualifying installment sale of real property, gain reported for any taxable year is the proportion of the installment payments received in that year which the gross profit, realized or to be realized when payment is completed, bears to the total contract price. Section 1.453-6(a)(2), Income Tax Regs., provides an exception to this general rule in that

> [i]f the obligations received by the vendor have no fair market value, the payments in cash or other property having a fair market value shall be applied against and reduce the basis of the property sold, and if in excess of such basis shall be taxable to the extent of the excess. * * *

Determinative of petitioners' right to report gain under this exception, and the crux of the parties' disagreement, is whether the land contract has an ascertainable fair market value.

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[5] As applicable during the years before the Court, section 453(b)(2) provided that gain could be reported under the installment method "if in the taxable year of the sale or other disposition--

(A) there are no payments, or

(B) the payments (exclusive of evidences of indebtedness of the purchaser) do not exceed 30 percent of the selling price."

If it does, respondent is correct that gain must be reported under the normal installment method, i.e., proportionally as payments are received.

Petitioners bear the burden of proving that respondent's deficiency determination is incorrect. Rule 142(a). In carrying this burden, petitioners must address, and overcome, the directive of section 1.453-6(a)(2), Income Tax Regs., which provides that "[o]nly in rare and extraordinary cases does property have no fair market value."

Numerous cases cited by respondent support the proposition that, in Michigan, land contracts are accepted as evidence of indebtedness, are freely traded, assignable and pledged and that purchase of such contracts at discount is a common practice in the State. Darby Investment Corp. v. Commissioner, 37 T.C. 839 (1962), affd. 315 F.2d 551 (6th Cir. 1963); Wood v. Commissioner, 25 T.C. 468 (1955). See also Heller Trust v. Commissioner, 382 F.2d 675 (9th Cir. 1967), affg. in part and revg. in part two Memorandum Opinions of this Court; Perelman v. Commissioner, 41 T.C. 234 (1963). More to the point, absent unique circumstances, which do not appear to be present in this case, such land contracts have ascertainable fair market values, albeit perhaps not equal to their face value.

Petitioners contend that the land contract in issue "was without negotiable instrument and, thus, had no fair market value." Therefore, according to petitioners, the transaction remains open and gain need be reported only after their basis has been recovered. However, the authority cited by petitioners does not support the blanket proposition that an accompanying negotiable instrument is a prerequisite to the marketability of a land contract. Guffey v. United States, 222 F. Supp 461 (D. Or. 1963), affd. 339 F.2d 759 (9th Cir. 1964).[6] Nor is there any evidence to indicate that the instant case is "rare and extraordinary" in that the land contract in issue does not have an ascertainable fair market value.

In arguing that the land contract does not have an ascertainable fair market value, petitioners contend that Northwestern would have to consent to a sale of the contract and that, possibly, petitioners would remain liable on the outstanding mortgage if they sold the land contract. Nothing in the record supports this speculation. Even if correct, while these limitations may result in a lower fair market value they would not make such value unascertainable.

Petitioners also argue that, since the monthly payments are less than the accruing interest, the $150,000 limitation of the purchasers' liability on default decreases in proportion to value and the likelihood of finding a purchaser for the land contract decreases with the passage of time. This argument ignores the fact that the balance of the Northwestern mortgage declines over time, the purchasers are required to complete $50,000 of improvements within 12 months and, on default, the land contract holder may obtain damages of up to $150,000 as well as possession of the property.[7] Even if we assume the limited liability on default would impact negatively on fair market value, this fact alone does not compel the conclusion that the land contract has no ascertainable fair market value.

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[6] In fact, the appellate court opinion indicates that, after the district court decision, taxpayer's counsel moved for a new trial seeking leave to produce evidence as to fair market value of the contract in issue and counsel for the government conceded that such a contract can have a fair market value. Guffey v. United States, 339 F.2d 759, 760 (9th Cir. 1964).

We find that the land contract in issue has an ascertainable fair market value and that gain must be reported as payments are received.

Decision will be entered

under Rule 155.

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[7] If repossession occurs, the value of the land may well exceed the outstanding balance due on the land contract given the $10,000 earnest money payment and $185,000 paid at the execution of the land contract. Additionally, the property may have appreciated in value.

COMPLETED

742-B

Ju 11.7/2: 1986-18

T. C. Memo. 1986-18

UNITED STATES TAX COURT

RANDALL K. GROSSE, Petitioner *v*.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 34872-84. Filed January 14, 1986.

Randall K. Grosse, pro se.

Ronald T. Jordan, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

HAMBLEN, *Judge*: This case is before the Court on respondent's motion for summary judgment pursuant to Rule 121[1] and respondent's motion for an award of damages under section 6673.

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[1] All rule references are to the Tax Court Rules of Practice and Procedure. Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect for the taxable year in issue.

ORIGINAL

Respondent issued a notice of deficiency to petitioner on July 12, 1984. In the notice of deficiency, respondent determined a deficiency in petitioner's Federal income tax for the taxable year 1981 in the amount of $4,312.30 and imposed additions to tax under the provisions of section 6651, section 6653(a)(1), and section 6653(a)(2) in the respective amounts of $349.99, $215.62, and 50 percent of the interest due on the $4,312.30 determined deficiency in tax.

In his petition filed with this Court, petitioner relates only general (and frivolous) allegations such as he (referring to himself as "the Sovereign") is a "natural person" and is not a "person" within the purview of section 61, that the income tax is a direct tax which respondent would impose upon him contrary to the provisions of Article I of the U. S. Constitution, that the 16th Amendment to the Constitution is not applicable to him, and other tax protester diatribe of like ilk which need not be dignified by repeating here. No error is assigned nor facts in support of such error in the petition which addresses the issues of the notice of deficiency. See Rules 34(b)(4) and (5).

Respondent filed his motion for summary judgment and motion for award of damages on September 23, 1985. Petitioner was served with a copy of each of these motions. By order dated October 22, 1985, petitioner was allowed 30 days to respond to these motions. On November 22, 1985, petitioner requested an extension of time to file his response to respondent's motions, which was granted, and on December 18, 1985, petitioner timely filed his objection to the motions. Petitioner's objection, like his petition, contains only tax protester jargon and arguments, repetitious of his petition except that his petition was only 14 pages long, whereas his objection was extended to (sans exhibits) 25 garrulous pages of ludicrous, irrelevant and frivolous tax protester gibberish.

Motion for Summary Judgment

A decision will be rendered on a motion for summary judgment if the pleadings, answers to interrogatories, depositions, admissions, and any other acceptable materials, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that a decision may be rendered as a matter of law. Rule 121(b). A fact is material if it "tends to resolve any of the issues which have been properly raised by the parties." C. Wright, A. Miller & M. Kane, 10A Federal Practice and Procedure: Civil, sec. 2725 (2d ed. 1983).[2] Our rules require that the petition contain clear and concise assignments of each error which petitioner alleges to have been committed by respondent. Rule 34(b)(4); Jarvis v. Commissioner, 78 T.C. 646,

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[2] Summary judgment under Rule 121 is derived from rule 56, Federal Rules of Civil Procedure. Hence, in any question turning on the interpretation of Rule 121, the history of rule 56, Fed. R. Civ. P., and the authorities interpreting such rule are considered by the Tax Court. See Hoeme v. Commissioner, 63 T.C. 18, 21 (1974); Shiosaki v. Commissioner, 61 T.C. 861, 862 (1974).

658 (1982). Any issue not raised in the assignments of error shall be deemed conceded. Rule 34(b)(4); Jarvis v. Commissioner, supra at 658.

Here, petitioner has not raised any justiciable facts or issues. The language of petitioner's alleged assignments of error and "facts" supporting such assignments are worn-out tax protester assertions which are overly familiar to us. This Court and other courts have repeatedly and consistently rejected petitioner's inanimate arguments as meritless and frivolous. See, e.g., Abrams v. Commissioner, 82 T.C. 403, 405 (1984); Rowlee v. Commissioner, 80 T.C. 1111, 1119-1122 (1983). Consequently, we find that there is no genuine issue of material fact, and respondent is entitled to summary judgment as a matter of law.[3]

Motion for Damages

Section 6673 provides, in pertinent part:

> Whenever it appears to the Tax Court that proceedings before it have been instituted or maintained by the taxpayer primarily for delay or that the taxpayer's position in such proceedings is frivolous or groundless, damages in an amount not in excess of $5,000 shall be awarded to the United States by the Tax Court in its decision. * * *

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[3] We note that this petition did not state a claim upon which relief could be granted and could have been dismissed by an appropriate motion under Rule 40. See Young v. Commissioner, T. C. Memo. 1983-65.

Here, petitioner in his petition and in his response to respondent's motion for summary judgment raises only worn-out meritless arguments. His failure to respond meaningfully to respondent's motion for summary judgment coupled with his clearly frivolous petition convinces us that petitioner's primary purpose was not to utilize this Court as a forum to litigate a genuine tax controversy but only to express his dissatisfaction with the Federal income tax system and to delay the payment of his Federal tax obligations, the common thread of all such tax protester abuses of the process of this Court.

Consequently, upon a review of this record, we find that this proceeding was instituted and maintained primarily for delay and that petitioner's position in this proceeding was frivolous and groundless. We accordingly award damages to the United States in the amount of $3,500.00.

To reflect the foregoing,

An appropriate order and
decision will be entered.

COMPLETED 742-B

Ju 11.7/2: 1986-19

T. C. Memo. 1986-19

UNITED STATES TAX COURT

DAISHO D. MIYAGAWA AND EMIKO A. MIYAGAWA, Petitioners
v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 4644-83. Filed January 15, 1986.

John Patrick Kelly, for the petitioners.

John O. Kent, for the respondent.

MEMORANDUM OPINION

FAY, Judge: With respect to petitioners' 1977 Federal income tax, respondent determined a deficiency of $15,814.00 and an addition to tax of $790.70 under section 6653(a).[1]

The issues are (1) whether petitioners may deduct certain claimed "advanced minimum royalties" under section 1.612-3(b)(3),

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the year in issue. All Rule references are to the Tax Court Rules of Practice and Procedure.

ORIGINAL

Income Tax Regs., (2) whether petitioners are liable for an addition to tax under section 6653(a), and (3) whether damages should be awarded under section 6673.

The facts have been fully stipulated and are so found.

Petitioners, Daisho D. Miyagawa and Emiko A. Miyagawa, resided in Playa Del Rey, Calif., when they filed their petition herein.

Petitioners timely filed a joint Federal income tax return for 1977 on which they listed their respective occupations as "Correctional Counselor" and "Fashion Designer." This case grows out of petitioners' involvement in a now familiar coal lease tax shelter involving "minimum annual royalty payments," most of which may be paid by means of nonrecourse notes which are exclusively payable from mining receipts.[2]

During November 1977, petitioners entered into a "Mining Lease" with Cambridge Corporation (herein, "Cambridge"). Under this lease, which was actually a sublease, petitioners were entitled to mine all of the economically recoverable coal at a specific location in Wyoming for a period of 5 years plus the remainder of 1977. Petitioners agreed to pay Cambridge a lease deposit of $100.00 and a royalty of $2.50 per net ton of the initial 24,000 tons of coal sold or mined, removed and marketed. Petitioners further agreed to pay Cambridge a minimum annual royalty payment of $24,000.00. The minimum royalty payment was to be recoverable out of the amount received from coal sold or mined, removed and marketed. The lease provided that in the event petitioners sold coal in place by means of a carved out production payment or otherwise, they would be obligated to pay a royalty to Cambridge to the same extent as if coal had been mined removed and marketed. Petitioners and Cambridge also executed an "Addendum to Mining Lease," under which petitioners, as lessees, were given the option of paying the minimum annual royalty payments due on December 31, 1978 and thereafter either in cash or by nonrecourse note. If payment by nonrecourse note was desired, petitioners were to pay Cambridge from all coal mined from the leased premises in excess of the initial 15,600 tons. Petitioners also entered into a "Contract for the Sale of Coal" with Poly-Tex International Inc. (herein, "Poly-Tex"), under which they purported to sell 15,600 tons of economically recoverable coal reserves to Poly-Tex at $3.50 per ton, for a total purchase price of $54,600.00. Of this amount, $27,000.00 was to be paid in cash, while the remaining $27,600.00 was evidenced by a promissory note payable on or before December 31, 1978. This sale was said to constitute the creation of a "carved out production payment."

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[2] Except for differences in the amounts "invested," and minor variations in detail, the facts of this case are substantially similar to those in Oneal v. Commissioner, 84 T.C. 1235 (1985), as well as other cases involving coal mining leases. See King v. Commissioner, T.C. Memo. 1985-340; see also Lund v. Commissioner, T.C. Memo. 1985-342; Kaji v. Commissioner, T.C. Memo. 1985-341; Rosebrough v. Commissioner, T.C. Memo. 1985-339; Ward v. Commissioner, T.C. Memo. 1984-570 on appeal (9th Cir., Jan. 14, 1985); Thompson v. Commissioner, T.C. Memo. 1984-337; Walls v. Commissioner, T.C. Memo. 1983-504; Nichols v. Commissioner, T.C. Memo. 1985-338.

During 1977, petitioners paid $12,000.00 to Cambridge by check, and also transferred to Cambridge an additional $27,000.00, representing the proceeds of the sale of coal to Poly-Tex, pursuant to an "Authorization to Negotiate."

No coal was produced during 1977 on the property leased by petitioners.

On their 1977 joint Federal income tax return, petitioners claimed a deduction of $39,000.00 for royalties in respect of the Cambridge lease.[3] In his notice of deficiency, respondent disallowed petitioners' claimed royalty deduction in full.

The first issue is whether petitioners are entitled to a deduction for royalties during the year in issue.[4] Under

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[3] Of the $39,000.00 amount, petitioners characterize $24,000.00 as payment of a minimum annual royalty and the remaining $15,000.00 as payment of their obligation under the mining lease to pay Cambridge a royalty payment to the same extent as if coal had been mined, removed and marketed, in the event they sold coal in place.

[4] In their petition herein, petitioners sought an award of attorneys' fees. Given our disposition of this case, it is clear that any claim by petitioners for attorneys' fees is wholly lacking in merit. See sec. 7430. Moreover, Rule 34(b) provides that a claim for reasonable litigation costs shall not be included in the petition in a deficiency action. See also Rule 231. We thus do not consider any such issue to be properly before us.

In their petition, petitioners also asserted that the assessment and collection of tax for 1977 is barred by the statute of limitations. However, we assume that they have abandoned this contention, since they have presented no evidence with respect thereto, nor have they argued it on brief. Moreover, the parties have attached to the stipulation of facts a copy of Form 872, dated August 29, 1980, by which petitioners agreed pursuant to sec. 6501(c)(4) to extend the time for assessment of their 1977 Federal income tax to December 31, 1982,

(footnote continued)

section 1.612-3(b)(3), Income Tax Regs., if no mineral product is produced during a given year, no deduction for royalties is allowed for that year unless the royalties are paid or accrued as a result of a minimum royalty provision.[5] In the instant case,

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(footnote continued from previous page)
and a copy of a U.S. Postal Service Form 3877 dated December 30, 1982, indicating that the notice of deficiency upon which this case was based was sent to petitioners by certified mail on December 30, 1982. It would thus appear that the notice of deficiency, dated December 30, 1982, was timely issued prior to the expiration of the statute of limitations as thus extended, and that assessment and collection of the tax for 1977 is not barred thereby. See secs. 6501(a), 6501(c)(4), 6503(a).

[5] Sec. 1.612-3(b)(3), Income Tax Regs., provides in relevant part as follows:

> The payor shall treat the advanced royalties paid or accrued in connection with mineral property as deductions from gross income for the year the mineral product, in respect of which the advanced royalties were paid or accrued, is sold. For purposes of the preceding sentence, in the case of mineral sold before production the mineral product is considered to be sold when the mineral is produced (i.e., when a mineral product first exists). However, in the case of advanced mineral royalties paid or accrued in connection with mineral property as a result of a minimum royalty provision, the payor, at his option, may instead treat the advanced royalties as deductions from gross income for the year in which the advanced royalties are paid or accrued. See section 446 (relating to general rule for methods of accounting) and the regulations thereunder. For purposes of this paragraph, *a minimum royalty provision requires that a substantially uniform amount of royalties be paid at least annually either over the life of the lease or for a period of at least 20 years, in the absence of mineral production requiring payment of aggregate royalties in a greater amount*. For purposes of the preceding sentence, in the case of a lease which is subject to renewal or extension, the period for which it can be renewed or extended shall be treated as part of the term of the original lease. * * * [Emphasis added.]

since no coal was produced during 1977 on the property leased by petitioners, the royalties in issue are deductible only if paid as a result of a minimum royalty provision. Under the regulation, a minimum royalty provision is one which requires that a substantially uniform amount of royalties be paid at least annually either over the life of the lease or for a period of at least 20 years.

Respondent contends that the amount claimed by petitioners as a deduction for royalties was not paid as a result of a minimum royalty provision within the meaning of section 1.612-3(b)(3), Income Tax Regs. In support of his position, respondent relies upon the terms of the "Addendum to Mining Lease" which allows petitioners to make each minimum annual royalty payment due December 31, 1978 and thereafter by means of a nonrecourse note. Under the terms of the nonrecourse note, payment would only be made from all coal mined in excess of the initial 15,600 tons. Petitioners argue that the claimed royalties were paid as a result of a minimum royalty provision. Alternatively, they assert that section 1.612-3(b)(3), Income Tax Regs., is invalid.

This Court has considered the issue raised herein in a number of cases involving substantially identical facts, most recently in Oneal v. Commissioner, 84 T.C. 1235 (1985). All of the transactional documents executed by petitioners herein, including the "Mining Lease," the "Addendum to Mining Lease," the "Non-Recourse Promissory Note," the "Authorization to Negotiate," and the "Contract for the Sale of Coal," are substantially similar to those executed by the taxpayers in Oneal v. Commissioner, supra. The only differences are the amounts involved and certain minor variations in detail. In Oneal, we sustained respondent's disallowance of the taxpayers' claimed royalty deductions. Consistent with our prior opinions involving substantially similar facts,[6] we held that where, as here, future royalty payments may be made by means of a nonrecourse note which is payable only in the event of mineral production, any royalties paid will not be considered to have been paid pursuant to a provision which requires that a substantially uniform amount of royalties be paid each year of the lease, and accordingly, will not be considered to have been paid as a result of a minimum royalty provision within the meaning of section 1.612-3(b)(3), Income Tax Regs. Our holding in Oneal v. Commissioner, supra, and the cases therein cited, is controlling on this point. Thus, for the reasons discussed in those cases, we hold that since no coal was produced during 1977 on the property leased by petitioners and since petitioners did not pay royalties as a result of a minimum royalty provision, petitioners' claimed royalty deduction is not allowable under section 1.612-3(b)(3), Income Tax Regs.

Petitioners contest the validity of section 1.612-3(b)(3), Income Tax Regs., notwithstanding that this Court and two circuit courts of appeal have upheld the validity of the regulation. See

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[6] See Ward v. Commissioner, supra; Thompson v. Commissioner, supra; and Walls v. Commissioner, supra.

Wendland v. Commissioner, 739 F.2d 580 (11th Cir. 1984); Redhouse v. Commissioner, 728 F.2d 1249 (9th Cir. 1984); Wing v. Commissioner, 81 T.C. 17 (1983); Wendland v. Commissioner, 79 T.C. 355 (1982). Each of the arguments raised by petitioners on this point has previously been addressed and rejected by this Court, most recently in Oneal v. Commissioner, supra, in which we again upheld the validity of section 1.612-3(b)(3), Income Tax Regs. See Oneal v. Commissioner, supra at 1239, and cases cited therein. In view of the foregoing, we dismiss petitioners' arguments concerning the validity of section 1.612-3(b)(3), Income Tax Regs., and hold thereunder that petitioners' claimed deduction for royalties is not allowable. We thus hold for respondent on this issue.

The second issue is whether petitioners are liable for an addition to tax under section 6653(a). That provision imposes an addition to tax equal to 5 percent of the underpayment if any part thereof is due to negligence or intentional disregard of rules and regulations. Petitioners bear the burden of proof on this issue. Enoch v. Commissioner, 57 T.C. 781, 802 (1972). Petitioners' position is clearly contrary to the express terms of section 1.612-3(b)(3), Income Tax Regs., and we consider the underpayment in this case to have been due at least to negligence, if not intentional disregard of that regulation. In any event, petitioners have failed to address this issue, and thus have not carried their burden of proof with respect thereto. Accordingly, we sustain the imposition of this addition to tax as determined in the notice of deficiency.

The final issue is whether damages should be awarded under section 6673. Under that section, as applicable herein, the Court may award damages to the United States of up to $5,000.00 when the proceeding has been instituted or maintained by the taxpayer primarily for delay or if the taxpayer's position in such proceeding is frivolous or groundless. We conclude that the award of damages is appropriate in this case since, on this record, we find that petitioners' position is frivolous and groundless and that these proceedings have been maintained by petitioners primarily for delay.

Prior to the submission of this case for our consideration, this Court had considered the deductibility of royalty payments on facts substantially identical to those presented herein. See *Ward v. Commissioner*, *supra*; *Thompson v. Commissioner*, *supra*; and *Walls v. Commissioner*, *supra*. In each of these cases, we held that the claimed royalties were not deductible. Moreover, petitioners raise the same issues concerning the validity of sec. 1.612-3(b)(3), Income Tax Regs., already decided adversely to them in *Wendland v. Commissioner*, *supra*; *Redhouse v. Commissioner*, *supra*; *Wing v. Commissioner*, *supra*; *Ward v. Commissioner*, *supra*; and *Walls v. Commissioner*, *supra*. Prior to the submission of this case, the Court of Appeals for the Ninth Circuit (to which the instant case is appealable) had already affirmed our decision in *Wendland v. Commissioner* (sub nom. *Redhouse v. Commissioner*), and the Eleventh Circuit had also done so. Petitioners were thus given adequate notice regarding similar cases involving substantially identical facts and were provided notice of the law of the circuit to which their case is appealable. Notwithstanding the well-established precedent, petitioners have persisted in maintaining these proceedings, but have presented us with no new or meritorious arguments to distinguish their case from those previously decided.[7] In *Oneal v. Commissioner, supra*, we awarded damages to the United States in the amount of $10,000.00 ($5,000.00 as to taxpayers Oneal and $5,000.00 as to taxpayers Lund) and admonished other taxpayers and their counsel not to maintain similar proceedings before this Court. We deem it appropriate to similarly award damages here since petitioners' case is essentially indistinguishable from that case. Accordingly, on respondent's motion, damages in the amount of $5,000.00 will be awarded to the United States under section 6673.

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[7] We note that the brief submitted by petitioners in this case appear to be a prepackaged, pro forma presentation substantially identical to those briefs filed by taxpayers in other cases involving coal lease tax shelters, most notably Wyoming and Western Coal Reserves, Inc. In fact, petitioners' brief erroneously asks us to find as a fact that petitioners "entered into a coal lease with Wyoming and Western Coal Reserves, Inc." Cf. *Oneal v. Commissioner*, *supra* at 1244. Among the promotional documents concerning these coal lease tax shelters is a letter from Joseph R. Laird, Jr., attorney at law, who is president of both Cambridge Corporation and Wyoming and Western Coal Reserves, Inc. Therein, Laird personally guarantees that legal representation will be provided to "investors" such as petitioners in this case in the event the Internal Revenue Service attacks the proposed tax treatment.

To reflect the foregoing,

An appropriate order will be entered on respondent's motion for damages, and decision will be entered for respondent.